DOCUMENT RESUME

ED 402 884 HE 029 827

AUTHOR	Wood, Marcia R.
TITLE	Consolidating Financial Statements.
INSTITUTION	National Association of Coll. and Univ. Business Officers, Washington, D.C.
REPORT NO	ISBN-1-56972-000-2
PUB DATE	95
NOTE	133p.; Partially supported by a grant from the Follett College Stores Fund for Financial Management.
AVAILABLE FROM	National Association of College and University Business Officers, One Dupont Circle, Washington, DC 20036 ($40 members; $60 nonmembers).
PUB TYPE	Guides - Non-Classroom Use (055) -- Books (010)
EDRS PRICE	MF01/PC06 Plus Postage.
DESCRIPTORS	Accounting; *College Administration; Educational Finance; Financial Audits; Financial Policy; Higher Education; Money Management; *Nonprofit Organizations; Private Schools; *School Accounting; School Business Officials; *Standards
IDENTIFIERS	American Institute of Certified Public Accountants; Financial Accounting Standards Board; Financial Analysis; *Financial Reports; Government Accounting Standards Board

ABSTRACT

This publication is designed to be a desktop reference and assist financial officers in both public and independent institutions of higher education in the preparation of consolidated financial statements. Chapter 1 covers generally accepted accounting principles and other accounting literature, and summarizes reporting rules of the Financial Accounting Standards Board (FASB) and the Government Accounting Standards Board (GASB). Chapter 2 describes methods of consolidation and reviews reporting relationships between two or more not-for-profit organizations and between not-for-profit and for-profit organizations. Chapter 3 focuses on elimination of intercompany transactions and conformity of accounting principles and display. Six appendices reprint, in whole or in part, consolidation guidelines, standards, and policies of the FASB, GASB, and the American Institute of Certified Public Accountants. (CH)

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Consolidating Financial STATEMENTS

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Consolidating Financial Statements

❖ Marcia R. Wood ❖

National Association of College
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Library of Congress Cataloging-in-Publication Data

Wood, Marcia.
Consolidating financial statements / Marcia Wood.
p. cm.
ISBN 1-56972-000-2
1. Nonprofit organizations—United States—Accounting.
2. Nonprofit organizations—United States—Accounting—Case studies.
3. Subsidiary corporations—United States—Accounting—Case studies.
4. Financial statements, Consolidated—United States. I. Title
HF5686.N56W66 1995
657'.98—dc20 95-34001
CIP

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and University Business Officers
One Dupont Circle
Washington, DC 20036

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Printed in the United States of America

Edited by Anne Kendrick
Designed by Stacey Trey

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Acknowledgments

The author gratefully acknowledges the contributions of Kenneth D. Williams of Coopers & Lybrand, who served as advisor and editor throughout the development of *Consolidating Financial Statements.* A debt of gratitude is also owed to Dr. Michael S. Patterson of California State University, Northridge, and Ann C. Patterson of the University of Southern California, both of whom provided invaluable editorial guidance during the manuscript's early stages and were instrumental in improving the organization and content of the book.

Consolidating Financial Statements is made possible through a grant from the Follett College Stores Fund for Financial Management. The fund, which was developed to help NACUBO satisfy growing demand for cutting-ege financial management information, underwrites the development of various projects that address higher educational financial management issues. NACUBO extends its appreciation to Scott Deaton, National Vice President of Marketing for Follett College Stores, who was instrumental in developing the fund and oversees its operation. ❖

Preface

Consolidating Financial Statements is designed to assist financial officers of both public and independent institutions in consolidating their financial statements with those of their institutions' related entities or subsidiaries. This publication is intended to serve as a desktop reference for chief financial officers, controllers, and their staff.

Chapter 1 covers generally accepted accounting principles and other accounting literature pertaining to consolidation procedures. The chapter summarizes reporting rules issued by the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB)—as well as other pertinent statements, opinions, bulletins, etc.—that influence the way in which colleges, universities, and other not-for-profit entities consolidate their financial statements.

Chapter 2 describes methods of consolidation that are currently recognized as acceptable and the applicability of these methods to colleges and universities. This chapter also reviews relationships between two or more not-for-profit organizations and between a reporting not-for-profit and a for-profit organization.

Chapter 3 focuses on reporting issues related to consolidation, namely elimination of intercompany transactions, conformity of accounting principles, and display.

Consolidating Financial Statements also contains a case study that demonstrates the application of principles described in the book. The case study applies these principles by presenting scenarios involving five subsidiary relationships with a parent institution.

Appendices A through F contain reprinted copies of the consolidation guidelines, standards, and policies covered in this publication. These pronouncements—which come from FASB, GASB, and the American Institute of Certified Public Accountants (AICPA)—are reprinted in their entirety or in part, depending on their relevance to the issues addressed in the book.

Although the guidance upon which *Consolidating Financial Statements* is based is the most up-to-date information available at the time of publication, much of this documentation is still under review and subject to change. Once pronouncements are released in their final forms, NACUBO will publish a revised edition of this book. ❖

Introduction

Financial officers at colleges and universities are charged with the important task of preparing financial statements that provide a fair presentation of their institutions' economic resources, obligations, and net resources. However, in the increasingly broad and complex world of higher education finance, this task is proving more and more challenging. Accurate reporting is further complicated by the financial relationships many institutions have entered into with both not-for-profit and for-profit entities.

In the past, reporting standards in higher education have not been consistently or comparably applied. As a result, users of financial statements often have difficulty analyzing one institution's financial information with that of other colleges or universities. Because the primary users of these statements include rating agencies, bond underwriters and other creditors, donors, taxpayers, and boards of trustees—a group that ranks second only to students as the major provider of economic resources—the importance of providing clear and accurate financial information cannot be overemphasized.

According to Financial Accounting Standards Board (FASB) Concepts Statement No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, not-for-profit organizations should report in their financial statements information "that is useful to resource providers . . . in making rational decisions about the allocation of resources to those organizations . . . [which] is comprehensible to those who have a reasonable understanding of an organization's activities and are willing to study the information with reasonable diligence" (paragraph 35). Paragraph 43 further states that "financial reporting should provide information about the economic resources, obligations, and net resources of an organization and the effects of transactions, events, and circumstances that change resources and interests in those resources." These two statements make it clear that consolidation is an accounting issue that should be addressed in the college and university environment.

Consolidation involves combining the financial statements of the parent institution with those of its related entities after inter-entity payables, receivables, and transactions have been eliminated. In the final presentation of consolidated financial statements, it appears as if the group of consolidated entities were a single entity.

The most important issues to consider in determining whether a related entity should be consolidated are control, ownership, and economic interest. The relationship between a not-for-profit reporting entity and a for-profit entity has in the past resulted in varied reporting. This situation often has resulted from homogeneity issues or cases where ownership of a majority voting interest or a large minority interest has enabled the not-for-profit to control the for-profit entity. Because of the absence of stock issuance, ownership issues between not-for-profit organizations are even more confusing. In many cases the aspect of control in the not-for-profit environment is more subjective, focusing on board control, working relationships and agreements, and ultimate economic benefit.

Independent universities that report under FASB rules are required to follow Statement of Financial Accounting Standards No. 94, *Consolidation of All Majority-Owned Subsidiaries* (SFAS No. 94), which amended Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (ARB No. 51); Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* (APB No. 18); along with the American Institute of Certified Public Accountants' (AICPA) Statement of Position 94-3, *Reporting of Related Entities by Not-for-Profit Organizations* (SOP 94-3). These pronouncements comprise the generally accepted accounting principles for reporting related entities in the financial statements of independent colleges and universities.

Public universities that report under the rules of Governmental Accounting Standards Board (GASB) follow GASB Statement No. 14, *The Financial Reporting Entity* (GASB No. 14) for direction on combining issues. The standards for public institutions refer more to combined financial statements and related entities than to the traditional concepts of consolidation, which is in keeping with the fund presentation model that is used by governmental organizations.

GASB No. 14 creates standards in the governmental (including governmental colleges and universities) arena for defining the financial reporting entity and its component units. The GASB exposure draft, *The Financial Reporting Entity—Affiliated Organizations*, is a proposed update to GASB No. 14. This exposure draft,which is included as appendix E of this guide, brings additional considerations to the entities to be included in the reporting organizations financial statements. ❖

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Generally Accepted Accounting Principles and Other Accounting Literature

This chapter covers generally accepted accounting principles (GAAP) and other published accounting guidelines that address consolidation issues. It summarizes Financial Accounting Standards Board (FASB) and Governmental Accounting Standards Board (GASB) standards that affect the reporting practices of independent and public institutions, analyzes other rulings and opinions on consolidations, and provides guidance for financial officers who must use these principles to determine the extent to which their institutions' subsidiaries should be consolidated and disclosed.

Generally Accepted Accounting Principles

Accounting Research Bulletin No. 51 (ARB No. 51) was issued in August 1959 and remained the authoritative accounting principle on consolidation until the release of Statement of Financial Accounting Standard No. 94 (SFAS No. 94) in October 1987. Before FASB Concepts Statement No. 4 was issued in December 1980, most colleges and universities either did not consider ARB No. 51 applicable to college and university financial reporting or used the exclusion paragraphs on nonhomogeneity to avoid consolidating their subsidiaries' financial statements with their own. In the past, many in the nonprofit sector have felt that since "generally accepted accounting principles" did not (until recently) specifically apply to not-for-profit organizations, tremendous leeway existed as to how these principles might be individually or collectively employed. FASB Concepts Statement No. 4 was FASB's first attempt to address the financial reporting requirements of a nonbusiness organization and to define the distinctions between nonbusiness and business organizations. Concept statements do not, however, create accounting principles, nor do they change or amend current accounting principles. FASB recognizes that certain inconsistencies may exist between nonbusiness and business financial reporting requirements. SOP 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations*, clarified the issue of applicability of accounting standards to not-for-profit organizations, and reference should be made to that pronouncement when questions arise concerning the applicability of any of policies and guidelines discussed in this chapter.

ARB No. 51, Consolidated Financial Statements (As Amended)

Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (ARB No. 51), establishes the basic principal and requirement for consolidation—that when a parent company has a controlling financial interest in a subsidiary company, consolidated statements provide a more fair and meaningful presentation than separate statements. SFAS No. 94, which is discussed below, amended ARB No. 51 and now provides the basic standards and guidelines for consolidation. Sections of ARB No. 51 that are still applicable and the basis for accounting guidance are outlined as follows.

ARB No. 51 specifies that an exclusion based on differing fiscal periods is not appropriate. The most ideal reporting circumstance is when the parent and subsidiaries have the same fiscal periods. However, it is generally acceptable to consolidate statements in cases where the reporting difference is no greater than three months, with the difference disclosed in the footnotes. When the difference in reporting periods is greater than three months, the preferred method is to adjust the financial statements of the subsidiary to that of the reporting parent. In this situation, the consolidation policy should be clearly disclosed either in the statements themselves or in the footnotes.

According to ARB No. 51, the appropriate procedure for consolidation is to eliminate inter-organization balances and transactions. It is important to remember, however, that eliminations apply not only to the balance sheet but also to the statement of activity. Preparers of financial statements should also keep in mind that Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations* (SFAS No. 117), provides that "interfund" balances should be eliminated for financial reporting in as much as they are not assets or liabilities of the entity as a whole.

When an organization is acquired during the year by a not-for-profit entity, two basic methods are used to reflect the consolidation of the operations of the acquired entity. The most widely used method of both for-profit and not-for-profit entities is to include only the revenue and expenses of the subsidiary from the date of acquisition. The other method is to include the subsidiary as though it had been acquired at the beginning of the year and deduct the preacquisition earnings at the bottom of the income statement. This second method does not appear to be prevalent in actual practice. The unique structure of the statement of activities that colleges and universities use allows for a variety of ways to show the consolidation of a subsidiary. For this reason, institutions should fully explore this area with their external auditors to determine the most effective display for a fair presentation.

APB No. 18, The Equity Method of Accounting for Investments in Common Stock

After ARB No. 51, Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* (APB No. 18), was the next pronouncement issued that dealt with accounting for investments in related entities. APB No. 18 reaffirmed the concept of consolidation and took it one step further by providing the guidance on accounting in situations where less than a controlling interest exists but the investment enables the investor to exercise significant influence over the operating and financial policies of an investee. APB No. 18 stipulates that, in this situation, the investor must use the equity method and follow very specific accounting, reporting, and disclosure requirements for investments for which the equity method is required. Although APB No. 18 was amended by FASB SFAS No. 94 (described below), its basic guidance is still the authoritative literature on accounting for transactions using the equity method.

FASB SFAS No. 94, Consolidation of All Majority-Owned Subsidiaries

FASB Statement of Financial Accounting Standards No. 94, *Consolidation of All Majority-Owned Subsidiaries* (SFAS No. 94), which was released in October 1987, basically reaffirmed the concept of consolidation under ARB No. 51 and the use of the equity method under APB No. 18, but eliminated the exceptions that had been provided in those statements. SFAS No. 94 requires consolidation of all majority-owned subsidiaries unless control is temporary or does not rest with the majority owner, as in a case of bankruptcy or corporate reorganization. The statement also makes clear that for use as general purpose financial statements, parent company statements are not a valid substitute for consolidated financial statements. This becomes very significant in relation to SFAS No. 117's requirement that entities must be reported as a whole.

As part of its project on the reporting entity, FASB is currently reconsidering consolidation of related entities or subsidiaries controlled by virtue of a significant minority interest, a contract or lease, an agreement with other stockholders, trust relationships, or a court decree.

AICPA Statement of Position 94-3, Reporting of Related Entities by Not-for-Profit Organizations

The American Institute of Certified Public Accountants (AICPA) Not-for-Profit Organizations Committee Statement of Position 94-3, *Reporting of Related Entities by Not-for-profit Organizations* (SOP 94-3), was released on September 2, 1994, and is effective for financial statements issued for fiscal years beginning after December 15, 1994. The SOP makes an exception for not-for-profit organizations with less than $5 million in total assets and less than $1 million in annual expenses, which are allowed an additional year before implementation is required.

SOP 94-3 provides specific guidance for implementing ARB No. 51, APB No. 18, and SFAS No. 94 as they relate to specific not-for-profit investment issues. The SOP considers the entities' relationships and the nature of their activities as the primary determinants of consolidation and the extent of disclosure. SOP 94-3 also requires reporting a not-for-profit organization to consolidate the statements if it owns a majority voting interest in the for-profit organization.

In accordance with APB No. 18, SOP 94-3 also requires use of the equity method of accounting for reporting an interest in a for-profit entity when the reporting not-for-profit has a large minority interest (but less than a 50 percent voting interest) and the reporting entity has the ability to exercise significant influence over the operating and financial policies of the investee. However, if the reporting not-for-profit reports all of its investments at market value (an acceptable practice for colleges and universities) it is not required to use the equity method.

Financially interrelated not-for-profit organizations should be consolidated when the reporting not-for-profit exercises control (through a majority ownership or majority voting interest on the board) and has an economic beneficial interest in the related not-for-profit. If control exists by means other than a majority ownership[1] or majority voting interest on the board and an economic beneficial interest exists, then the reporting not-for-profit may consolidate but is not required to do so. Under these conditions, if the statements are not consolidated, the reporting not-for-profit is required to disclose in the footnotes the name of the subsidiary, its relationship to the reporting organization, and the financial data.

SOP 94-3 makes it clear that both an economic beneficial interest and "control," must exist before consolidation of two interrelated not-for-profit entities is required. Control is defined in SOP 78-10, *Accounting Principles and Reporting Practices for Nonprofit Organizations,* as the "direct or indirect ability to determine the direction of the management and policies through ownership, by contract, or otherwise (paragraph 42). According to SOP 78-10 and 94-3, economic beneficial interest exists when:

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[1] Control can exist in various forms including by contract, by lease, or by agreement with other shareholders.

"a) . . . entities solicit funds in the name of . . . the reporting organization, and . . . the funds solicited are intended . . . or otherwise required to be transferred to the reporting organization or used at its discretion or direction.
b) A reporting organization transfers . . . its resources to another . . . entity whose resources are held for the benefit of the reporting organization.
c) A reporting organization assigns functions to a controlled entity whose funding is primarily derived from sources other than public contributions."

SOP 94-3 is intended to amend and make uniform the audit guides *Voluntary Health and Welfare Organizations, Colleges and Universities,* and *Certain Nonprofit Organizations,* and SOP 78-10. SOP 94-3 will be incorporated into the AICPA's new not-for-profit audit and accounting guide, which will consolidate and supersede the existing audit guides.

FASB has ongoing projects on consolidations and related matters (of which Discussion Memorandum No. 107-A, described later in this chapter, is only one phase). The ultimate resolution of these projects could change the current and recommended reporting guidelines, but completion dates for these projects are difficult to predict.

GASB Statement No. 14, The Financial Reporting Entity

GASB Statement No. 14, *The Financial Reporting Entity* (GASB No. 14), released in June 1991, defines the financial reporting entity based on the concept of financial accountability. In this context, financial accountability is analogous to control and level of ownership. The financial reporting entity is the primary government (including all organizations that define its legal entity), organizations that report to the primary government, and other organizations that have a relationship with the primary government of such significance that to exclude them would lead to incomplete financial statements.

GASB No. 14 goes on to define a component unit of a primary government as one that is fiscally dependent on the primary government. The component unit does not have the authority "to adopt its budget, levy taxes or set rates or charges, or issue bonded debt without approval by the primary government." According to the statement, public colleges and universities would be defined as component units of the primary government. The statement makes clear that the rules for combined reporting apply equally to component units.[2]

Financial accountability is defined in GASB No. 14 as the ability to appoint a voting majority of the board of another entity *and* either (1) the ability to "impose its will" on the other entity, or (2) the potential to receive economic benefits or liabilities from the other entity.

The structure of this statement makes clear that a majority voting interest on the board might not, by itself, determine control. The ability of the reporting entity to significantly influence the operating activities or services of the component unit defines the reporting entity's ability to "impose its will." This is the more classic definition of control, with the term "majority voting interest" taking on the aspects of level of ownership. In this situation, GASB then says that control, as previously defined, does not need to exist if level of ownership exists and the *potential* for financial benefit or burden exists.

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[2] In further discussions of GASB Statement No.14, the term "component unit" will be substituted for primary government and will mean public colleges and universities and/or their subsidiaries.

Under the GASB rule, a financial benefit or burden is present if the component unit "(a) is legally entitled to or can otherwise access the organization's resources; (b) is legally obligated or has otherwise assumed the obligation to finance the deficits of, or provide financial support to, the organization; or (c) is obligated in some manner for the debt of the organization."

The definition of display requirements is more specific under the GASB rule than under FASB rules. GASB identifies three types of presentations: discrete, blended, and disclosure. A discrete presentation incorporates separate columns in the reporting entity's financial statements to present the component's financial activity. A blended presentation is used when the activities between the reporting entity and the component unit are so intertwined as to be part and parcel of each other. A disclosure presentation in the notes is required to distinguish between discretely presented components and blended components, as well as to describe the component units and their relationship to the reporting entity. Disclosure is also required for unconsolidated activities. Relationships with other organizations, joint ventures, jointly governed organizations, and governments require footnote disclosure. The GASB statement was effective for fiscal years beginning after December 15, 1992.

Other Accounting Literature

Aside from the FASB and GASB standards described above, several other principles and guidelines have been released that affect the way in which colleges, universities, and other not-for-profit entities handle consolidation issues in their financial statements. This section describes these principles and explains the effect of each on not-for-profit reporting practices.

FAS Discussion Memorandum No. 107-A, Consolidation Policy and Procedures

The Financial Accounting Series (FAS) Discussion Memorandum No. 107-A, *Consolidation Policy and Procedures* (DM No. 107-A), was issued on September 10, 1991. DM No. 107-A does not specifically address the needs or requirements of not-for-profit organizations, which are addressed in the FAS preliminary views on consolidation policy, another phase of the broad project on consolidations. Recent FASB pronouncements are taking the not-for-profit sector into a realm of financial reporting that is far more similar to business enterprises than was the case in the past. FASB recognizes that the resolution of consolidation issues for business enterprises could affect the way these issues are resolved for not-for-profit organizations. The most critical areas that may be affected are control and ownership. The definitions of control and ownership—and the need for one or the other or both to be present for consolidation—will be key points, since ownership alone has less applicability in the not-for-profit sector than it does in the business sector.

DM No. 107-A presents seven issues as the primary factors for consideration in developing the policies and procedures for preparing consolidated financial statements. Since this is a discussion memorandum, no specific conclusions are drawn. Rather, FASB provides alternatives and invites public response before reaching its final decisions. Several of the issues have subissues, and only those relevant to colleges or universities will be presented here.

> **Issue 1**: Issue 1 addresses conditions pointing to consolidation of a subsidiary. This issue is primary to all others in the decision to consolidate and revolves around (a) the concepts of control and ownership, (b) whether one or both is necessary, (c) the determination of when they

exist (e.g., in fact or by presumption), and (d) the extent to which a beneficial interest exists in a subsidiary. This issue is presented in depth in chapter 2.

Issue 2: Issue 2 deals with the treatment of a subsidiary's assets and liabilities in the consolidated statements at the date of acquisition.

Issue 3: Issue 3 covers changes in a parent's proportionate interest in a subsidiary resulting from purchases and sales of the subsidiary's stock.

Issue 4: Issue 4 addresses elimination of intercompany payables, receivables, sales, purchases, and profits and losses. This issue deals with the sale of inventory between parent and subsidiary, in both directions, and the sale of assets between two subsidiaries.

Issue 5: Issue 5 covers display of noncontrolling minority interests in consolidated statements.

Issue 6: Issue 6 deals with conformity of accounting policies in consolidated statements.

Issue 7: Issue 7 addresses differing fiscal periods between a subsidiary and a reporting parent.

FAS Preliminary Views Document on Consolidation Policy

FAS Preliminary Views (PV) Document on Consolidation Policy was issued on August 26, 1994, with a comment period through December 31, 1994. This document is intended to address the consolidation requirements of not-for-profit organizations, as well as other entities, and will result in an exposure draft on consolidation policy that will amend and update ARB No. 51 and SFAS No. 94. The PV takes the position that the economic relationship between organizations—and the resulting control of one organization over another—is a more significant determinant of affiliated organizations (and thus a better indicator of the need for consolidation) than the organizations' legal form or their ownership of a majority voting interest. This document expands both the scope and the concept of consolidation policy.

The PV lists three issues as determinants in consolidation policy:

Issue 1: Control is defined as the ability of a controlling organization to have the "power to use or direct the use of the individual assets of [a controlled entity] to achieve the objectives of the controlling entity." Does that definition properly apply to not-for-profit organizations?

Issue 2: The definition of the objective of a not-for-profit organization is "to provide needed goods or services to its beneficiaries or other constituents." Does this description aid in determining the application of the control concept?

Issue 3: If control exists but with a minimum level of equity ownership or other beneficial interest, should consolidation be precluded? The tentative conclusion is that consolidation should still apply.

The document discusses the forms of control. *Legal control* employs the same definitions used in SFAS No. 94, and *effective control* expands the definition of control to include issues of consolidation in not-for-profit organizations. Effective control is still a difficult concept to employ and requires professional judgment regarding the relationship between organizations. *Presumptions and indicators of control* are defined in the document to help resolve the question of effective control.

In a not-for-profit situation, achieving the objectives of a controlling entity is further defined as providing "needed goods or services to its beneficiaries or other constituents." Control is further defined as the ability to influence the use of assets either *directly* or *indirectly*.

Legal control is direct control that includes majority voting rights, with or without majority ownership (exceptions are rare), and the ability to appoint a majority of the members of the board. Effective control is indirect control that includes substantial minority voting interests to the extent that other minority shareholders are overshadowed by the controlling entity's ability to vote its shares and, thereby, direct the use of the controlled entity's assets. Also included is the situation where a self-perpetuating governing board of a not-for-profit organization is established by the controlling entity. Even though the controlling entity cannot appoint future board members, it may influence current board members on the election of future board members.

Effective control can be presumed if an entity has the ability to "elect or appoint a majority of the members of [the controlled entity's] governing board without the legal right to do so." Two other presumptions of control involve "the ability to take control at will in the future without significantly increasing an investment in the [controlled] entity" and "control through restrictions on a corporation's activities in its charter or bylaws. Control is presumed unless there is clear and overriding evidence to the contrary."

According to the PV, many indicators of effective control can help determine whether an entity is in fact controlled by another. Indicators are aspects of the relationship between organizations that suggest or demonstrate the ability of one organization to control the activities of another. Multiple indicators tend to establish credibility that a controlled relationship exists.

The FAS Preliminary Views Document on Consolidation Policy is reprinted in appendix E.

GASB Exposure Draft, The Financial Reporting Entity—Affiliated Organizations

The GASB Exposure Draft (ED), *The Financial Reporting Entity—Affiliated Organizations*, was issued on December 9, 1994, with a comment deadline of February 28, 1995, and an expected effective date for financial statements for periods beginning after December 15, 1995. The statement amends paragraphs 21, 41, and 53b of GASB No. 14 and establishes standards for the definition of an affiliated organization and for determining whether it is a component unit of the primary government's reporting entity and describes how it should be included for financial reporting purposes.

According to the ED, an affiliated organization meets all of the following criteria:

1. The organization "has separate legal standing, where neither direct association through appointment of a voting majority of the organization's governing body nor fiscal dependency exists."
2. The affiliation with the primary government is stated in the articles of incorporation.
3. The affiliation with the primary government is stated in the application to the Internal Revenue Service for tax exempt status.

The organization is a component unit of the primary government if the primary government can impose its will on the organization "or if there is potential for the organization to provide specific financial benefits to, or impose specific financial burdens on, the primary government." A discrete presentation is required in the financial statements of the reporting entity.

Financial benefits not paid directly to the primary government should be reported as follows:

1. Salaries and fringe benefits on behalf of primary government employees should be classified as transfers-out and transfers-in, in accordance with [GASB] No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance*, paragraph 14.
2. Other payments for which the primary government is legally liable, such as utility bills, should also be reported as transfers-out and transfers-in.

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The Holder Report

The Holder Report is a research report published in 1986 by FASB titled *The Not-for-Profit Organization Reporting Entity.* This report, written by Professor William W. Holder of the University of Southern California, discusses the legal organizational structure of not-for-profit organizations, their financial reporting practices, and the needs of the users of financial reports. Holder identifies deficiencies in financial reporting as perceived by users of financial statements. Among the central issues are (1) the reliability of financial information and (2) the need for audited general purpose financial statements prepared in accordance with GAAP.

The Holder Report identifies a variety of relationships between separate entities that can point to common control. According to the report, the most common relationships are formed through the following means:

1. Ownership (legal ownership through stock or other means, such as membership in a membership corporation)
2. Board membership (the ability to appoint or elect a majority of the board or the voting majority of the board of one entity, by virtue of its bylaws, becomes the voting majority of another entity's board)
3. Charter or bylaws (the corporate charter limits the activities of an entity to those beneficial to another entity)
4. Contract (relationship defined in a written contract)

Applying GAAP for Reporting Consolidations

Despite the uncertainties and incompleteness of principles and guidelines for not-for-profit reporting, GAAP can and should be applied to not-for-profit organizations in the area of consolidations. The application of prudence, materiality, and thoughtful interpretation can help institutions determine the extent to which its subsidiaries should be consolidated and/or disclosed. Frank discussion between a college or university and its external auditors regarding issues of materiality and the use of the equity method can offer reassurance as to the fairness of the presentation and also preserve the external auditor's unqualified opinion. When external auditors have a clear understanding of an institution's relationships with not-for-profit subsidiaries and its investments in for-profit organizations, they can offer advice on consolidation procedures and policies. While such policies are still under review and subject to change, it is prudent to involve an external accounting firm in determining the requirements for full consolidation. ❖

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Conditions and Methods of Consolidation

Determining whether the need for consolidation of related entities exists and deciding how to go about consolidating once a need is established are two challenges commonly confronted by those charged with preparing the financial statements of a college or university. This chapter explores the circumstances that necessitate consolidation and summarizes the methods available for consolidating financial statements.

Conditions of Consolidation

The conditions for consolidation in the not-for-profit sector are divided into two distinct sets of circumstances: (a) the relationship between two or more not-for-profit organizations and (b) the parent/subsidiary relationship between a not-for-profit entity and a for-profit organization.

Relationships Between Two or More Not-for-Profit Organizations

The two necessary conditions pointing toward consolidation are control and economic interest. In a purely not-for-profit environment, the level of ownership is generally not determined by the number of shares owned or whether those shares represent a majority voting interest.[3] More commonly, the equivalent to the ownership concept can be construed as the ability to control, for example through the ability to appoint the board or through majority voting interest ***on the board*** and as an economic interest in the related not-for-profit.

Control is defined as the ability to directly or indirectly determine the direction of management and policies through ownership, by contract or otherwise, of another entity. SFAS No. 94 and GASB No. 14 address control exercised through ownership of a majority voting interest in another entity. Other forms of control (such as by contract, lease, court decree, or significant minority ownership) were not specifically addressed in SFAS No. 94. However, SOP 94-3 provides guidance in the college and university environment stating that control includes the ability of the reporting not-for-profit entity to appoint (from its board, officers, or employees) a majority of the board of the separate entity.

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[3] Ownership can take various legal forms in the not-for-profit environment, including shares of stock, ownership certificates, membership certificates, joint ventures, and partnerships.

When an economic beneficial interest exists along with control in a form *other than a majority voting interest on the board* (for example through contract or affiliations), consolidation is permitted, but not required. If either control or economic beneficial interest exists—but not both—consolidation is precluded. In all three cases, a fair presentation requires that the footnotes contain full disclosure of the relationship between the two entities and the financial information of the unconsolidated entity.

GASB No. 14 also precludes consolidation for forms of ownership other than a majority voting interest on the board. However, the GASB discussion of control implies that a majority voting interest and the ability of an organization to impose its will on another are not one and the same in terms of defining control. This distinction is important because under GASB rules only a majority voting interest on the board is required for the condition of control to be established. Further, if no economic benefit or liability is present but the organization does have the ability to impose its will along with a majority voting interest, the conditions for consolidation have been met.

Independent colleges and universities typically have few not-for-profit-related entity relationships which are not already included in their financial statements. Public colleges and universities have more frequently formed legally separate and unconsolidated not-for-profit relationships than independent institutions. Customary examples of not-for-profit subsidiary relationships which should be considered for consolidation under both sets of rules would be auxiliary operations (dining, housing, and bookstores), public radio stations, research and fund-raising organizations, and hospitals.

Relationships Between Reporting Not-for-Profit Organizations and For-Profit Organizations

In a relationship between a reporting not-for-profit and a for-profit entity, the principles that apply should reflect the ownership (stock) interest in the for-profit entity. Under the FASB pronouncements, the concepts of control and economic beneficial interest are not considered in relation to an investment in a related for-profit entity. Under GASB pronouncements, once both the conditions of control (ability to impose its will) and level of ownership (majority voting interest) are present, any discussion of economic benefit or liability is specious in determining if the conditions for consolidation are present.

College and university investment portfolios have generally included ownership interests in for-profit entities shown as investments. These investments have been reflected in the financial statements based on the entity's policy for accounting for cost or market investments.

If the level of ownership is less than 50 percent but more than 20 percent of the voting rights of the voting stock, the equity method of accounting is appropriate for the investment. Consolidation is not appropriate in this situation. If the ownership interest is greater than 50 percent of the voting rights of the voting stock, then the entity should be consolidated. The following discussion represents an approach to consolidation within the spirit of SFAS No. 94, SOP 94-3, and other authoritative accounting literature. Adoption of any aspect of this approach should be done in consultation with the entity's external auditors.

Assume that a reporting university located in an oil-rich area owns or receives 100 percent of the voting stock of an oil company. The university decides to retain the stock for its portfolio and participate in the management and financial policies of the oil company. The requirement for consolidation exists. External factors—such as the economic well-being of the area, or the possibility that a change in the status of the oil company may affect the area's economy or that the university may be acting in accordance with the public service aspects of its mission—are not relevant to the consideration of which accounting principles are applied.

In a slightly different scenario, assume the university owns or receives less than 100 percent, but still a substantial majority interest, of the oil company's voting stock. The university retains the stock in its portfolio because it provides a good return on investment and disposing it would adversely affect the value of the investment. The board has implemented a policy stipulating that the institution cannot hold more than a 5 percent equity interest in another entity and must dispose of this investment over time.[4] In this case, the control is temporary and consolidation is not required and would not be appropriate. The equity method of accounting along with disclosure of the relationship in the footnotes of the university's financial statements would be adequate.

Finally, assume that this single investment represents over 30 percent of the university's endowment. Materiality becomes a significant factor in this case, affecting not the consideration to consolidate but the consideration of display and reporting in the financial statements.

In the above examples a public university would normally own or receive this ownership interest through a separate foundation or fund-raising organization, and the issues of consolidation would apply to the fund-raising organization but not directly to the university. A strict adherence to the GASB rules would absolutely require consolidation under all three scenarios. The university then faces the issues of consolidating its fund-raising organization. Most public universities are considering the issues related to consolidating the financial statements of the fund-raising organizations; however, in most cases the conditions for consolidation under GASB No. 14 would be met and consolidation would be required. Further, the nature of the fund-raising organization is so integral to the university that a blended display is the credible presentation.

These examples demonstrate the need to involve external auditors in the process of determining the appropriate requirements for consolidation. The auditors must know and understand the university's investment philosophy as well as the nature, extent, and *intent* of the university's relationship with a for-profit entity when that relationship exhibits the conditions of control and level of ownership.

When a college or university creates or purchases a for-profit entity that has as its purpose the furtherance of the mission of the college or university, the requirements for consolidation are clearly present. However, in the relationship with a for-profit entity it is the ownership interest that controls the consideration of consolidation.

As described earlier in this guide, consolidation is the combination of the financial statements of the parent and related entities after the elimination of inter-entity payables, receivables, and transactions. In the final presentation, the group of consolidated entities appears as a single entity. In the previous example of an endowed bequest, the consolidation would be reported in the column of the university's statements for permanently restricted net assets. Since current accounting convention does not recognize "expenses" in permanently restricted net assets, it may be acceptable to report the net results of operations (after appropriate eliminations) in the "revenues and other changes" section of the statement on either the "investment and other income" line or the "net gains and losses" line. The balance sheet should fully incorporate the assets, liabilities, and equity of the subsidiary. It may be preferable to show these lines separately from the assets, liabilities, and net assets of the reporting entity. A separate presentation allows the reader to see the impact of the consolidation of the subsidiary. Rating agency analysts and others who calculate and use ratios will find this presentation helpful in seeing the complete picture of the reporting entity and its subsidiary relationships. Additional disclosure in the footnotes may be appropriate to fully portray the nature of the subsidiary and its relationship to the reporting entity.

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[4] The acquisition and sale of blocks of stock in a subsidiary over time would indicate that if control were present at the outset (such as in a gift transaction), it would not be in the future and therefore control would only be temporary. Temporary control is not a condition that warrants consolidation.

Methods of Consolidation

There are three acceptable methods of consolidation: the economic unit concept, the parent company concept, and the proportionate interest concept. Each of these methods—as well as the equity method, which is an alternative to consolidation that has been used for reporting an investment in an unconsolidated entity—are described below.

Economic Unit Concept

Also known as the entity theory, the economic unit concept presumes that in consolidation the entire entity makes up one economic unit. The group of entities that make up this one entity are operated under a single management. This management is represented by both the controlling and noncontrolling stockholders. All of the assets, liabilities, revenues, and expenses of the subsidiaries are combined in the parent company statements. Since both the controlling and noncontrolling groups are part of the proprietary group, their interests are presented respectively in the net equity section of the consolidated balance sheet.

Parent Company Concept

The parent company concept emphasizes the interests of the parent company, rather than those of a larger group. Under this concept, the parent's investments in and gains and losses from its subsidiary are replaced in the consolidated financial statements with the minority interest and 100 percent of the subsidiary's assets, liabilities, revenues, expenses. Whereas the minority (noncontrolling) interest under the economic unit concept is part of the stockholder's equity this interest is displayed under the parent concept somewhere between liabilities and stockholders' equity.

The differences between the economic unit concept and the parent company concept have to do with noncontrolling interests. If a subsidiary is wholly owned, no differences exist between the two methods.

Proportionate Interest Concept

The proportionate interest concept is a variation of the parent company concept in which the noncontrolling interests in the subsidiary are excluded entirely from the parent company's financial statements. Under this method, the parent company's investment in and gains and losses from a subsidiary are replaced with the parent company's proportionate interest in the assets, liabilities, revenues, and expenses of the subsidiary. The minority interest is excluded from the balance sheet entirely. The proportionate interest concept is probably the most commonly used method in higher education for consolidated related entities.

The Equity Method Alternative

The equity method is an alternative to consolidating financial statements. Under this method, a reporting organization accounts for its proportionate investment in the related entity. If a difference exists between the cost of the investment and the actual proportionate equity, the reporting organization should reflect this change through its income statement and balance sheet. Income from the investment (share of earnings and dividends) is reported in the financial statements of the investee. The cost method does not adjust the cost value of the investment (unless provision is required for a permanent impairment in value) and records income only when dividends are received.

The difference between consolidations and the equity method lies in the details reported in the financial statements. APB No. 18 describes the accounting principles applicable to the equity method of accounting for investments in common stock. The historical rule of thumb has been to use the cost method for ownership interests of less than 20 percent, the equity method for ownership interests between 20 and 50 percent, and to fully consolidate the statements for ownership interests greater than 50 percent.

Financial statements of colleges and universities are comparatively difficult to read. One argument for the equity method has been that it does not cloud the statements with financial data and information not directly related to the operations, assets, liabilities, and fund balances of the reporting organization. The appropriate presentation for entities accounted for by the equity method is a caption on the balance sheet showing the equity in and advances to unconsolidated related entities and a single line representing the results of operations of the entity in the income statement with additional disclosure in the footnotes.

Until FASB issues a standard on consolidation policy, the AICPA SOP 94-3 will set the applicable GAAP. In the meantime, as the most knowledgeable preparers and users of their statements, college and university business officers have a responsibility to work with FASB toward resolutions which provide for a clear and fair presentation of financial statements in accordance with generally accepted accounting principles. ❖

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Eliminations, Conformity, and Display

The most important issues involved in the preparation of consolidated financial statements are elimination of intercompany transactions, conformity of accounting policies, and display of consolidated information. This chapter provides guidance in each of these areas and describes the reporting options available.

Elimination of Intercompany Transactions

A complete consolidation eliminates all intercompany transactions, including unrealized profits (losses) on intercompany inventory transactions, receivables, payables, sales, and purchases. If subsidiaries are 100 percent owned, all intercompany transactions should be fully eliminated regardless of whether the economic unit, parent company, or proportionate interest concept is used.

As explained in chapter 2, the proportionate interest concept of consolidation is probably the most commonly used in higher education. For sales of inventory from the parent company to the subsidiary company ("downstream sales"), it is appropriate to eliminate intercompany receivables, payables, sales, purchases, *and* unrealized intercompany profits and losses resulting from inventory transactions but only to the extent of the parent company's proportionate share in the subsidiary. Under the proportionate interest concept, the noncontrolling interest is eliminated at the outset because noncontrolling interest is not reflected in the balance sheet of the consolidated statements. The same principles apply to inventory sales from a subsidiary company to the parent company ("upstream sales"). These principles also apply to other sales between parent and subsidiary, such as an intercompany sale of plant assets or the sale to the subsidiary of the goods the parent normally sells to outside customers.

Other alternatives do exist if either the economic unit or parent company concept is used. The primary differences revolve around the elimination of the unrealized intercompany profits and losses. Under the other two methods, 100 percent of the intercompany unrealized profits and losses are eliminated and either allocated to the parent company or allocated between the parent company and the noncontrolling interest.

Interest capitalization is another area where consolidated reporting may differ from individual statements. On a consolidated basis, interest may be capitalized in accordance with GAAP to the extent of the total interest actually incurred on a combined basis. (Refer to FAS No. 34 for a complete discussion of interest capitalization.) If a weighted average of the interest rate is used because the borrowing entity cannot identify amounts borrowed for specific capital assets that qualify for interest capitalization, the interest cost capitalized on a consolidated basis may be different from that reported individually.

Conformity of Accounting Policies

How should the accounting policies of the subsidiary be conformed to those of the parent? Generally, the accounting practice is *not* to change the accounting policies of the reporting parent organization. Rather, the accounting policies of the subsidiary are modified to conform with those of its parent. The purpose is to make the financial statements more informative regarding the parent's relationship with its subsidiaries, but not to the extent of changing the parent's accounting policies. Nor should the subsidiary's accounting policies be changed to agree with the parent's if the subsidiary's accounting practices are in accordance with GAAP. For example, the parent and subsidiary may use different methods of inventory valuation (e.g., FIFO and LIFO) for separate categories of inventory and may use different depreciation methods. Often the parent and subsidiary are in different industries with different accounting and reporting practices. In such cases it is not necessary to adjust the subsidiary's reporting to agree with that of the parent. Here again, footnote disclosure can be used to identify any material differences.

Display

In higher education, display may be a more difficult question than conformity of accounting policies. Because SFAS No. 117, *Financial Statements of Not-for-Profit Organizations,* does not prescribe a reporting format, various options may be available for display of consolidated financial information. For example, in consolidated financial statements, the operations of a hospital could be shown in the unrestricted net assets column or in a separate column within the unrestricted net asset classification exclusively for healthcare. Depreciation could appear in a column for plant activities or it could stay in the column with operations. Any of the above decisions would be allowed; appropriate disclosure in the footnotes or the financial statements would show how the consolidation was accomplished. One additional consideration in any presentation is the SFAS No. 117 requirement for functional reporting of expenses; which can be accomplished on the face of the statement or in the notes. The consolidation of the balance sheet presents fewer concerns because captions reflecting similar assets can be combined or shown discreetly. Certainly, separate columns could be combined to reflect the consolidated reporting entity.

In response to SFAS No. 117, some institutions are redesigning their financial statements to develop prototype statements, but much work remains. The ultimate goal is to produce general purpose financial statements that meet GAAP and provide adequate financial information and disclosures to users of the statements.

While FASB institutions have greater leeway in the display of consolidated statements, GASB has specifically identified the means by which consolidated component units (subsidiaries) should be displayed. A discrete presentation using separate columns is recommended for relationships that are distinct from the normal operating activities of the institution, such as a university-owned hospital (as described above). Blended presentation is required for relationships that are central to the normal activities of the institution, reporting the balances and transactions in a manner similar to the institution. Once again, to identify the results of operations and balances of these component units, displaying them by separate line item is appropriate if this provides more meaningful statements. Examples here include auxiliary activities and research and fund-raising foundations.

Disclosures are required to distinguish between discretely displayed component units and blended component units. The notes should include descriptions of the component units and their relationship with the institution. Disclosure should also be made regarding how the user can obtain the separately issued financial statements of the component units. Additional disclosures are required for relationships of the institution that are not consolidated in the financial statements, but nevertheless have a financial impact on the institution. GASB defines these relationships as "organizations other than component units, including related organizations, joint ventures, jointly governed organizations, and component units of another government with characteristics of a joint venture or jointly governed organization . . . [and] joint ventures in which the participating [institution] has an equity interest."

Differing Fiscal Periods

A difference in fiscal periods between a parent and subsidiary does not justify an exclusion from consolidation. Ideally the reporting periods of the parent and subsidiary should be the same. However, as discussed in chapter 1, a difference of no more than three months is widely recognized as acceptable for consolidation without adjusting the financial statements of the subsidiary to the same period as those of the reporting parent.

If more than three months exist between the two fiscal periods, it is appropriate to adjust the financial statements of the subsidiary to conform to the parent's reporting period. If more than three months exist between the ends of the entities' fiscal years, it would be appropriate to consolidate the subsidiary's quarterly financial statements closest to the parent's year end. Any prior accruals for the fiscal period of the subsidiary should be reversed, and new accruals should be calculated for the adjusted period. ❖

Conclusion

ARB No. 51, as amended by SFAS No. 94, comprises the generally accepted accounting principles employed for the consolidation of related entities in the financial statements for independent colleges and universities. AICPA SOP 94-3 specifically applies to not-for-profit organizations and remains the principal source of guidance for such organizations until FASB completes its study of the entire consolidation issue.

GASB No. 14 dictates GAAP for public colleges and universities. It supersedes NCGA Statement No. 7 and therefore overrides the use of FASB rules for consolidation of component unit financial statements.

Current accounting practice for consolidation varies widely in higher education. Many colleges and universities do not consolidate their statements. Many use the equity method of accounting instead of consolidation for reporting most of their related entity relationships. Others report their investment portfolios at market, which includes their interests in for-profit organizations. Colleges and universities that do a full consolidation (as in the typical case of a wholly owned hospital) use the proportionate interest method. In fact, in the majority of relationships, not-for-profit subsidiaries are wholly owned and therefore a minority interest is not in question. In hospital consolidations (and others) the specific reporting lines normally found in an income statement are not present in the consolidated statements primarily because of issues of display. The nature and display of income and expenses in higher education financial statements differ from those of a hospital.

Colleges and universities have many types of relationships with other entities, some of which clearly fall within the guidelines of SFAS No. 94 and GASB No. 14. Homogeneity issues and clarity of financial presentation cannot be arguments for excluding higher education from generally accepted accounting principles applicable to consolidation. FASB is addressing further issues and looking for input from our industry representatives. As users and preparers of higher education financial statements, business officers need to use an interpretive process to address the FASB questions of consolidation.

Although higher education is concerned about homogeneity, the concerns may be more about display and disclosure than about consolidation. When consolidation issues arise that are related to homogeneity, consolidation and display may be adequately resolved through discrete balance sheet and statement of activity presentation and full disclosure in the footnotes.

The balance sheet presentation should include current and long-term assets, current and long-term liabilities, and net equity of the related entities. SFAS No. 117 requires gross presentation, which would apply to the display of consolidated entity activities in the financial statements.

Disclosure in the footnotes should include all information pertinent to the financial condition of the related entity and its relationship with the reporting parent organization. Pertinent accounting policies, including accounting periods, depreciation methods, and items like depletion reserves, loss provisions, and tax considerations are examples of disclosures that if material should be clearly detailed. The GASB statement further requires disclosure that identifies the differences between blended and discretely presented component units and tells how to obtain the separately issued financial statements of component units.

The most conservative approach to the question of whether to consolidate is to examine the issues of control and level of ownership. If they are determined to exist in any construction, then it is appropriate to consolidate. If degree of control or ownership becomes a significant factor in the question then review and consultation with external auditors is appropriate. During the course of the audit, the subsidiary relationships of the college or university should become apparent to the auditors. ❖

Case Study

This case study demonstrates the reasons for consolidation and the various ways to display consolidated statements. Five subsidiary relationships with a parent university are presented. Case 1, University Hospital, and case 2, Practice Plans, describe two not-for-profit relationships that also have intercompany transactions between the two subsidiaries. The nature of the two subsidiaries presented in these cases is relatively common in higher education in both the public and private sector. While university hospitals and practice plans are distinct from education and research activities, they are integral to the success of the medical school within an institution. Case 3, University Real Estate Associates, describes a for-profit relationship to be consolidated. The for-profit enterprise was created by the parent university in this case, but it typifies many of the relationships a college or university would have with a for-profit organization in which it is actively involved. Case 4, Parent University Foundation, describes another not-for-profit relationship that is more typical of a public university. Case 5, The Downtown Book Cellar, describes a for-profit relationship created by virtue of a bequest that is not subject to consolidation. Taken together, these five cases demonstrate the subsidiary relationships most frequently entered into by colleges and universities. The applications here can be extrapolated to other specific relationships of any particular college.

In each of the five cases presented, the organization of the subsidiary, its relationship to the university, and intercompany transactions are described. The proportionate interest method of consolidation is used in all cases. For subsidiaries in which the university has 100 percent ownership, there is no difference between the proportionate interest method and the economic unity and parent company concepts. The Parent University referred to in each case can be either an independent or public institution. Situations where an institution's status as public or independent results in differences in consolidation will be identified in each case.

Colleges and universities use varying statements to report their financial position and results of operations. The AICPA SOP 94-3 has an effective date which coincides with the effective date of SFAS No. 116, *Accounting for Contributions Received and Made*, and SFAS No. 117, *Financial Statements of Not-for-Profit Organizations*. Because none of the prevailing accounting literature currently prescribes the display format, the cases do not describe assumptions about reporting formats for the purposes of consolidating statements. The basic statements of the entities to be consolidated are shown. If these entities are not-for-profit organizations, it is assumed, for these purposes, that all net assets are unrestricted. The Parent University trial balance is the work paper against which consolidations are shown. Eliminations and consolidation are done in one work paper against total net assets.

The trial balance of Parent University is presented in figure 1.

Case 1: University Hospital

University Hospital is a wholly owned not-for-profit hospital operated by Parent University. The hospital's board, which consists of 10 members, overlaps with the board of the university. Three members are university corporate officers, four are members of the university's board, and three are appointed by the hospital—one of whom is the dean of the medical school. The hospital started a major capital expansion in December 1990 and uses the university's resources for capital projects (e.g., planning, architect's fees, bidding, vendor contracts, oversight). The hospital is periodically billed by the university for the costs of such projects and reimburses the university for its expenditures. In fiscal year 1991, the project costs totalled $1,960,000, and the hospital reimbursed the university $750,000.

University Hospital receives tithing from the practice plans (see case 2) of 2 percent of their net patient revenues. This income is recorded as

Parent University
Trial Balance at June 30, 199X
($ in '000's)

	Total
Debits:	
Cash	$65,690
Accounts & Notes Receivable	51,098
Investments	316,364
Inventories, Prepaids, & Other	6,075
Interfund Balances	42,294
Land	37,298
Buildings, Equipment, and Library Books	291,833
Construction in Progress	24,700
Expenditures from Operations	355,685
Payments to Beneficiaries	1,674
Depreciation	17,266
Debt Retirement	5,292
Interest on Debt	6,407
Other Changes:	
Matured Trusts	491
Mandatory Transfers	9,402
Nonmandatory Transfers	10,188
Disposal of Plant Assets	649
Total Debits	$1,242,406

	Total
Credits:	
Current Liabilities	$52,578
Interfund Balances	42,294
Long Term Debt	149,719
Funds Held for Others	4,398
Tuition & Fees	144,772
State Appropriation	72,894
Endowment & Investment Income	28,225
Net Realized Gain on Investments	3,355
Government Contracts & Grants	80,062
Private Gifts	48,931
Sales & Service	4,386
Other Sources	3,040
Capitalization of Plant Assets	34,942
Other Changes:	
Matured Trusts	491
Mandatory Transfers	9,402
Nonmandatory Transfers	10,188
Beginning Net Assets	552,729
Total Credits	$1,242,406

Figure 1: Parent University, Trial Balance

Balance Sheet at June 30, 199X

($ in '000's)

Assets:	
Cash	$5,882
Patient Accounts Receivable	6,773
Inventory	958
Prepaids and Other	625
Total Current Assets	14,238
Property, Plant, and Equipment, net	17,369
Construction-in-Progress	1,960
Assets Limited as to Use	34,542
Unamortized Bond Discount	953
Total Assets	$69,062
Liabilities and Net Assets:	
Accounts Payable	$2,456
Accounts Payable University	$1,210
Accrued Liabilities	3,892
Total Current Liabilities	7,558
Bonds Payable	25,000
Capital Lease Obligation - long term portion	157
Net Assets	36,347
Total Liabilities and Net Assets	$69,062

Statement of Activities
Year Ending June 30, 199X
($ in '000's)

Revenues:	
Gross Revenue	$53,076
Less: Allowances and Uncollectibles	(11,284)
Net Revenue	41,792
Expenses:	
Operations	36,703
Depreciation and Amortization	2,194
Interest	62
Total Operating Expenses	38,959
Excess of Revenue over Expense from Operations	2,833
Nonoperating Income	1,302
Net Surplus	4,135
Beginning Net Assets	32,212
Ending Net Assets	$36,347

Figure 2: University Hospital Balance Sheet and Statement of Activities

nonoperating revenue. In addition, in fiscal year 1991 the hospital purchased land from University Real Estate Associates (see case 3) for $1,250,000. Both of the entities are subsidiaries of Parent University and meet the conditions for consolidation. The intercompany transactions between subsidiaries must also be eliminated during consolidation.

Healthcare services are a vital and integral part of the university and its medical school. The conditions for consolidation are met under both FASB and GASB rules. Full consolidation is appropriate, but the operations of the hospital and the private practices are so large that they could overshadow the university's activities in instruction and research. There is also a moral and quasi-legal obligation to segregate these funds. Balances for healthcare services are not available for the university's general purposes of education and research unless the hospital determines these balances to be so by transferring them to the university for its use. To make a clear distinction of the nature of these activities, the university decided to incorporate an additional column on its statement of activities as a subcategory of unrestricted net assets. This is the first year Parent University has consolidated University Hospital. This display format can also fall within the guidelines for a discrete presentation under GASB rules. GASB does not address the subject of depreciation. It may be dealt with separately or included along with the operating expenses of the hospital. Compensation paid on behalf of the primary government and other payments for which the primary government is liable should be reported as transfers in and transfers out, in accordance with paragraph 57 of GASB Statement No. 14 and paragraph 14 of GASB Statement No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance.*

Footnote Disclosures

1. The footnote containing significant accounting policies should name the entity being consolidated and the nature of its activities when a separate column is used for display.
2. A footnote describing the legal structure of the entity (e.g., a not-for-profit public benefit corporation organized under the laws of the state whose sole corporate member is Parent University).
3. Balances and activities that are commingled with the university's or reported net should be identified. For example, plant assets include $1,960,000 for construction in progress. Land totals $3,500,000; buildings and improvements total $3,487,000; net of accumulated depreciation of $5,270,000; net of accumulated depreciation of equipment of $10,132,000; and net of accumulated depreciation of $8,348,000. Current year depreciation equals $2,194,000. Accounts receivable net of allowances should be identified.
4. Major sources of revenue should be identified, especially with respect to federal government reimbursement principles.
5. Any debt guarantees or contingent liabilities that the hospital has entered into or that the university has guaranteed on behalf of the hospital should be disclosed.
6. Under GASB rules, information should be provided on how to obtain copies of the component unit's financial report.

Case 2: Practice Plans

In the early 1980s a medical school master plan that created private practice plans (by clinical specialty) was approved by Parent University's board of trustees. To practice in any of these plans, a physician must be a member of the medical school faculty. If a faculty member wishes to practice clinical medicine, he or she must be a member of one of the practice plans. The practice plans board includes the chair of each clinical department, the dean of the school of medicine, and one university officer. The practice plans are not-for-profit organizations.

The individual medical practices contribute 5 percent of their net patient revenues to the medical school and 2 percent of their net patient revenues to the hospital. Their net revenues are held for the benefit of their respective departments in the medical school. In accordance with the agreement, the university reimburses the practice plans for the salaries and wages of all nursing and administrative support personnel. The university invests the funds of the practice plans and distributes the investment income to them twice a year. On June 30, 1991, the income earned but not yet distributed was $361,000. The actual investments are recorded on the practice plans financial statements. University activity during the year is recorded in an intercompany account in Healthcare Services. To fund the annual expenditures, the university transfers funds from an internally designated account. During fiscal year 1991, the university borrowed $4 million from the practice plans for building renovations for a major program in genetic medicine. The $4 million is payable at 10 percent per year, interest only for five years. The interest had not been paid on June 30, 1991; the expenses and accounts payable were recorded on the university's books.

Parent University has chosen to display the activities of the practice plans in its consolidated statements in the column with University Hospital. This is the first year the university has consolidated the practice plans. As with the hospital, this display format is acceptable under both FASB and GASB rules. Compensation paid on behalf of the primary

Combined Balance Sheets at June 30, 199X
($ in '000's)

Assets:	
Cash	$365
Investments	14,158
Patient Receivables	6,938
Due from University	761
Total Current Assets	22,222
Investments	10,138
Due from University	4,000
Equipment	2,894
Total Assets	$39,254
Liabilities and Net Assets:	
Accounts Payable and Accrued Expenses	$3,704
Total Current Liabilities	3,704
Other Liabilities	7,359
Net Assets:	
Clinical Operations	18,847
Departmental Development Funds	9,344
Total Net Assets	28,191
Total Liabilities and Net Assets	$39,254

Combined Statements of Clinical Operations
Year Ending June 30, 199X
($ in '000's)

	Clinical Operations	Departmental Development Funds
Operating Revenue:		
Net Patient Service Revenues	$33,213	
Salary Reimbursements - University	4,893	
Total Operating Revenue	38,106	
Operating Expenses	31,628	
Depreciation	2,314	
Total Expenses	33,942	
Investment Income	1,447	
Contibutions to University (School of Medicine)	(1,230)	(431)
Contributions to Hospital	(358)	(306)
Net - Other Changes	(141)	(737)
Beginning Net Assets	14,824	10,081
Ending Net Assets	$18,847	$9,344

Figure 3: Practice Plans Combined Balance Sheets and Statements of Clinical Operations

government and other payments for which the primary government is liable should be reported as transfers in and transfers out in accordance with paragraph 57 of GASB No. 14 and paragraph 14 of GASB No. 24.

Footnote Disclosures

The footnote disclosures for case 2, Practice Plans, are the same as those listed in case 1, University Hospital.

Case 3: University Real Estate Associates

In fiscal year 1990, Parent University created a for-profit real estate development corporation for the purpose of building town homes and condominiums for faculty and staff and developing the land surrounding the campus. The capitalization of this corporation, University Real Estate Associates, came from a $3 million university investment. In return for the capital investment, the university received 3,000 shares of no par value stock and a guaranteed return of 6 percent of its investment annually. The university is the sole member of the

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Balance Sheet at June 30, 199X
($ in '000's)

Assets:	
Cash	$193
Receivables	4,493
Project Investments	11,668
Fixed Assets, net	1,816
Other Assets	125
Total Assets	$18,295
Liabilities and Stockholder's Equity:	
Current Liabilities:	
Accounts and Notes Payable	$810
Long Term Debt	14,102
Total Liabilities	14,912
Stockholder's Equity	3,000
Retained Earnings	383
Total Liabilities and Stockholder's Equity	$18,295

Statement of Operations and Retained Earnings
Year Ending June 30, 199X
($ in '000's)

Revenues	$15,587
Expenses	15,104
Net Income	483
Retained Earnings, Beginning of Year	(100)
Retained Earnings, End of Year	$383

Figure 4: University Real Estate Associates Balance Sheet and Statement of Operations and Retained Earnings

corporation. University Real Estate Associates was expected to show a profit after three years. The university used the cost method to report its relationship with this subsidiary in fiscal year 1990 on the basis of materiality. Its equity interest is carried at cost as a $3 million investment on the balance sheet. In fiscal year 1990 the corporation had an immaterial net loss that was not reflected in Parent University's financial statements. In fiscal year 1991 the corporation showed a profit of $483,000. (No liability for tax provisions is recorded for purposes of this case. This is an issue separate from consolidation.) University Real Estate Associates is currently negotiating with three other parties to develop a commercial and retail plaza costing in excess of $25 million. The outlook for this venture is positive; the corporation is already showing a profit and is expected to continue to do so. The corporation's visibility and relationship to Parent University are pronounced in the community. The conditions for consolidation exist, and the university will fully consolidate University Real Estate Associates beginning in fiscal year 1991.

In August 1990 University Real Estate Associates sold land to University Hospital for its capital expansion. The hospital used $1,250,000 of the proceeds from its tax-exempt bond issue to purchase the land. University Real Estate Associates purchased the land for $1 million in fiscal year 1990. Under GASB rules, this transaction is not an activity that would be blended with the balances and activities of the university. Thus, a discrete presentation is recommended in this case.

Footnote Disclosures

1. A footnote describing the legal structure of University Real Estate Associates and Parent University's level of ownership (e.g., a for-profit corporation organized under the laws of the state whose sole corporate member is Parent University).
2. Major activities of the organization and types of revenue should be identified.
3. Balances and activities that are commingled with the university's should be identified.
4. Condensed balance sheet and statement of operations should be displayed so that users can pull out the effects of the subsidiary if so desired. Major intercompany transactions which have been eliminated should be identified.
5. Any debt guarantees or contingent liabilities the entity has entered into or the university has guaranteed on behalf of the entity should be disclosed.
6. Under GASB rules, information should be provided on how to obtain copies of the component unit's financial report.

Case 4: Parent University Foundation

Parent University Foundation is a separately incorporated not-for-profit organization whose board is controlled by Parent University. The activities of the foundation are for the exclusive benefit of Parent University. The foundation is responsible for the auxiliary activities of the university, such as parking, dining, housing, stadium operations, and intercollegiate athletics. The foundation conducts these activities throughout the year and reflects a transfer of the estimated surplus from operations to the university. By June 30, 1991, the foundation had booked a transfer and accounts payable to the university of $3,216,000.

Because Parent University Foundation's activities are intertwined with the university, GASB rules would call for a blended presentation. Public universities usually show supplemental statements of operations of such a foundation. Typical functions performed for public universities by one or more

Combined Balance Sheets at June 30, 1991
($ in '000's)

Assets:	
Cash	$1,471
Accounts Receivable	11,089
Investments	9,666
Total Assets	$22,226
Liabilities and Net Assets:	
Accounts Payable	$12,018
Due to Parent University	3,216
Total Liabilities	15,234
Net Assets	6,992
Total Liabilities and Net Assets	$22,226

Combined Statement of Activities

Year Ending June 30, 199X
($ in '000's)

Operating Revenue	$21,471
Operating Expenses	17,540
Excess of Revenues over Expenditures	3,931
Transfer to Parent University	3,216
Net Increase in Fund Balance	715
Beginning Net Assets	6,277
Ending Net Assets	$6,992

Figure 5: Parent University Foundation Combined Balance Sheets and Statement of Activities

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separately incorporated organizations are parking, dining, housing, stadium operations, intercollegiate athletics, private gifts (including endowment investment and management), capital campaigns, student unions, student organizations, booster clubs, bookstores, and sponsored research. Independent universities do not usually create separate foundations for these purposes. For an independent university, the auxiliary activities are accounted for in unrestricted net assets.

Footnote Disclosures

1. A footnote describing the legal structure of Parent University Foundation and Parent University's level of ownership (e.g., a not-for-profit public benefit corporation organized under the laws of the state whose sole corporate member is Parent University).
2. Major activities of the organization and types of revenue should be identified.
3. Balances and activities commingled with the university's should be identified.
4. Condensed balance sheet and statement of operations should be displayed so that users can pull out the effects of the subsidiary if so desired. Major intercompany transactions that have been eliminated should be identified.
5. Any debt guarantees or contingent liabilities entered into by the entity or guaranteed by the university on behalf of the entity should be disclosed.
6. Under GASB rules, information should be provided as to how to obtain copies of the component unit's financial report.

Case 5: The Downtown Book Cellar

In fiscal year 1990 the university received a bequest from the estate of Mr. Doe, who left his 70 percent interest in the Downtown Book Cellar, the principal of which is to be held in perpetuity and the income to support the university library. The bookstore has three other owners who have 10 percent interests each in the store. The university is not precluded in the will from selling its interest in the bookstore. The university is actively negotiating with the other three owners to sell its interest and has no intention of retaining the interest in the bookstore.

In fiscal year 1990 the university recorded an investment asset and a permanently restricted gift of $1,488,000, which represented the fair market value at the date of receiving the gift. This amount is equal to the capital stock and retained earnings share of Mr. Doe on August 31, 1991 (the fiscal year end of the bookstore).[5]

Because control is determined to be temporary, after consulting with its auditors, the university decided that accounting for the investment using the equity method is appropriate.

In fiscal year 1991 the university recorded investment income of $279,000 and a gain (an increase in investment) of $191,000 ($470,000 share of earnings less $279,000 dividends declared and paid). The total investment on the university's books is now $1,679,000.

Footnote Disclosures

1. Nature of the gift and identification of the use of the equity method of accounting should be disclosed.
2. Major activities of the organization and types of revenue should be identified.
3. Condensed balance sheet and statement of operations should be displayed so that users can pull out the effects of the subsidiary if so desired.
4. Under GASB rules, information should be provided on how to obtain copies of the component unit's financial report.

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[5] In a real situation the estate would have to be appraised for tax purposes and the market value would most likely not be equal to the capital stock and retained earnings.

Balance Sheet at August 31, 199X
($ in '000's)

Assets:	
Cash	$248
Accounts Receivable	130
Merchandise Inventory	420
Plant and Equipment, net	2,003
Total Assets	$2,801
Liabilities:	
Accounts Payable	$459
Stockholder's Equity:	
Minority Interest:	
Capital Stock	234
Retained Earnings	429
Total Minority Interests	663
Controlling Interest:	
Capital Stock	546
Retained Earnings	1,133
Total Controlling Interests	1,679
Total Liabilities and Stockholder's Equity	$2,801

Statement of Operations and Retained Earnings
Year Ending August 31, 199X
($ in '000's)

Sales	$3,080
Cost of Goods Sold:	
Begining Inventory	702
Purchases	1,342
Ending Inventory	420
Cost of Goods Sold	1,624
Gross Profit on Sales	1,456
Expenses	356
Net Income before Taxes	1,100
Income Taxes	429
Net Income	671
Retained Earnings:	
Minority Interest:	
Retained Earnings B of Y	348
Minority Interest - Net Income 30%	201
Dividends Declared and Paid	120
Retained Earnings E of Y	429
Controlling Interest:	
Retained Earnings B of Y	942
Controlling Interest - Net Income 70%	470
Dividends Declared and Paid	279
Retained Earnings E of Y	$1,133

Figure 6: The Downtown Book Cellar Balance Sheet and Statement of Operations and Retained Earnings

Eliminations

1. Eliminate Parent University's receivable ($1,210) from hospital and hospital's payable to university for project costs not yet reimbursed on June 30, 1991.
2. Eliminate tithing ($664) from practice plans to University Hospital.
3. Eliminate gain ($250) on sale of land from University Real Estate Associates to University Hospital and reduce hospital land value to $1 million.
4. Eliminate practice plans tithing ($1,661) to university.
5. Eliminate Parent University salary reimbursements ($4,893) to practice plans.
6. Eliminate accrued investment income ($361) between Parent University and practice plans.

Trial Balances at June 30, 199X ($ in '000's)	Parent University Trial Balance	Hospital Trial Balance	Practice Plans Trial Balance	University Real Estate Associates Trial Balance	Parent University Foundation Trial Balance	Eliminations	Eliminations	Notes	Parent University Consolidated Trial Balance
Debits:									
Cash & Cash Equivalents	$65,690	$5,882	$14,523	$193	$1,471				$87,759
Accounts & Notes Receivable	51,098	6,773	6,938	4,493	11,089	($1,210)	($3,216)	*1 & 10*	75,965
Accounts Receivable - University			761			(361)	(400)	*6 & 7*	0
Investments	316,364		10,138		9,666				336,168
Inventories, Prepaids, & Other	6,075	1,583							7,658
Interfund Balances	42,294								42,294
Due from University			4,000			(4,000)		8	0
Project Investments				11,668					11,668
Land	37,298								37,298
Buildings, Equipment,									0
and Library Books	291,833		2,894	1,816					296,543
Construction in Progress	24,700								24,700
University Hospital Property, Plant , and Equipment		17,369				(250)		3	17,119
University Hospital Construction-in-Progress		1,960							1,960
Assets Limited as to Use		34,542							34,542
Unamortized Bond Discount		953							953
Other Assets				125					125
Less: Allowances and Uncollectibles		11,284							11,284
Operations		36,703							36,703
Expenditures from Operations	355,685		31,628	15,104	17,540	(4,893)	(180)	*5 & 9*	414,884
Contributions to University			1,661		3,216	(1,661)	(3,216)	*4 & 10*	0
Contributions to Hospital			664			(664)		2	0
Payments to Beneficiaries	1,674								1,674
Depreciation	17,266	2,194	2,314						21,774
Debt Retirement	5,292								5,292
Interest on Debt	6,407	62				(400)		7	6,069
Matured Trusts	491								491
Mandatory Transfers	9,402								9,402
Nonmandatory Transfers	10,188								10,188
Disposal of Plant Assets	649								649
Total Debits	1,242,406	119,305	75,521	33,399	42,982	(13,439)	(7,012)		1,493,162

Figure 7: Parent University Consolidations and Eliminations

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Trial Balances at June 30, 199X ($ in 000's)	Parent University Trial Balance	Hospital Trial Balance	Practice Plans Trial Balance	University Real Estate Associates Trial Balance	Parent University Foundation Trial Balance	Eliminations	Eliminations	Notes	Parent University Consolidated Trial Balance
Credits:									
Accounts Payable	52,578	2,456	3,704	810	12,018	(361)	(400)	*6 & 7*	70,805
Accounts Payable University		1,210			3,216	(1,210)	(3,216)	*1 & 10*	0
Accrued Liabilities		3,892							3,892
Other Liabilities			7,359						7,359
Interfund Balances	42,294								42,294
Long Term Debt	149,719	25,157		14,102		(4,000)		*8*	184,978
Funds Held for Others	4,398								4,398
Tuition & Fees	144,772								144,772
State Appropriation	72,894								72,894
Endowment & Investment Income	28,225		1,447			(580)		*9*	29,092
Net Realized Gain on Investments	3,355								3,355
Government Contracts & Grants	80,062								80,062
Private Gifts	48,931					(1,661)		*4*	47,270
Sales & Service	4,386					(3,216)		*10*	1,170
Other Sources	3,040								3,040
Patient Revenues		53,076	33,213						86,289
Nonoperating Income		1,302				(664)		*2*	638
Revenues				15,587	21,471	(250)		*3*	36,808
Salary Reimbursements - University			4,893			(4,893)		*5*	0
Capitalization of Plant Assets	34,942								34,942
Matured Trusts	491								491
Mandatory Transfers	9,402								9,402
Nonmandatory Transfers	10,188								10,188
Stockholder's Equity				3,000					3,000
Retained Earnings				(100)					(100)
Beginning Net Assets	552,729	32,212	24,905		6,277				616,123
Total Credits	1,242,406	119,305	75,521	33,399	42,982	(16,835)	(3,616)		1,493,162
Total	$0	$0	$0	$0	$0	$3,396	($3,396)		$0

Figure 7: Parent University Consolidations and Eliminations, continued.

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7. Eliminate accrued investment income on $4 million loan ($400) to university from practice plans.
8. Eliminate practice plans loan of $4 million to Parent University.
9. Eliminate investment income ($580) to Parent University from University Real Estate Associates.
10. Eliminate revenue and receivable on Parent University's books and transfer from foundation ($3,216). ❖

Pronouncements Applicable to Independent Institutions

Appendix A	**American Institute of Certified Public Accountants Statement of Position 94-3**
Appendix B	**Financial Accounting Series Preliminary Views on Conxolidation Policy**
Appendix C	**Other Pertinent Rulings**

Appendix A

American Institute of Certified Public Accountants Statement of Position 94-3

SUMMARY

This statement of position (SOP) amends and makes uniform the guidance concerning reporting related entities in the following AICPA publications:

- Industry Audit Guides *Audits of Voluntary Health and Welfare Organizations* and *Audits of Colleges and Universities*
- Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*
- SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*

The conclusions in this SOP are based on the premise that (1) whether the financial statements of a reporting not-for-profit organization and those of one or more other not-for-profit or for-profit entities should be consolidated and (2) the extent of disclosure that should be required, if any, if consolidated financial statements are not presented should be based on the nature of the relationship between the entities.

The guidance in this SOP focuses on (1) investments in for-profit entities and (2) financially interrelated not-for-profit organizations. That guidance includes the following:

Investments in For-Profit Entities

- A reporting not-for-profit organization should consolidate a for-profit entity in which it has a controlling financial interest through direct or indirect ownership of a majority voting interest if the guidance in Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, as amended by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 94, *Consolidation of All Majority-Owned Subsidiaries*, requires consolidation. The manner in which the for-profit entity's financial position, results of operations, and cash flows are presented in the reporting organization's financial statements depends on the nature of the activities of the for-profit entity.
- A reporting not-for-profit organization should use the equity method in conformity with Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, to report investments in common stock of a for-profit entity if the guidance in that Opinion requires the use of the equity method.
- Some AICPA audit guides applicable to some not-for-profit organizations permit investment portfolios to be reported at market value.

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Not-for-profit organizations that choose to report investment portfolios at market value in conformity with the AICPA audit guides may do so instead of reporting those investments by the equity method, which otherwise would be required by this SOP.

Financially Interrelated Not-for-Profit Organizations

- A not-for-profit organization should consolidate another not-for-profit organization in which it has a controlling financial interest through direct or indirect ownership of a majority voting interest, unless control is likely to be temporary or does not rest with the majority owner, in which case consolidation is prohibited, as discussed in paragraph 13 of FASB Statement No. 94.
- A not-for-profit organization should consolidate another not-for-profit organization if the reporting not-for-profit organization has both control of the other not-for-profit organization, as evidenced by either majority ownership or a majority voting interest in the board of the other not-for-profit organization, and an economic interest in the other not-for-profit organization, unless control is likely to be temporary or does not rest with the majority owner, in which case consolidation is prohibited, as discussed in paragraph 13 of FASB Statement No. 94.
- A not-for-profit organization may exercise control of another not-for-profit organization in which it has an economic interest by means other than majority ownership or a majority voting interest in the board of the other not-for-profit organization. In such circumstances, the not-for-profit organization is permitted, but not required, to consolidate the other not-for-profit organization, unless control is likely to be temporary, in which case consolidation is prohibited, as discussed in paragraph 13 of FASB Statement No. 94. If a not-for-profit organization controls another organization in which it has an economic interest by means other than majority ownership or a majority voting interest in the board of the other not-for-profit organization and consolidated financial statements are not presented, the not-for-profit organization should make the financial statement disclosures specified in paragraph 12.
- If either (but not both) control or an economic interest exists, the financial statement disclosures required by FASB Statement No. 57, *Related Party Disclosures*, should be made.

The conclusions in this SOP will be reconsidered when the FASB completes its project on consolidations and related matters, which may affect the definition of control and other related matters.

This SOP is effective for financial statements issued for fiscal years beginning after December 15, 1994, except for not-for-profit organizations that have less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date shall be for fiscal years beginning after December 15, 1995. Earlier application is permitted. For organizations that adopt FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, before its effective date, earlier application of this SOP is encouraged. Comparative financial statements for earlier periods included with those for the period in which this SOP is adopted should be restated.

Reporting of Related Entities by Not-for-Profit Organizations

Introduction

1. The purpose of this statement of position (SOP) is to provide guidance to users and preparers of not-for-profit organizations' financial statements that will produce greater uniformity and comparability in the reporting of investments in majority-owned for-profit subsidiaries, investments in less than 50-percent-owned for-profit entities, and related but separate not-for-profit organizations. This SOP does not address how to prepare consolidated financial statements,[1] nor does it address all the conceptual issues underlying the reporting of relationships not evidenced by ownership.[2]

Scope

2. This SOP—

- Amends and makes uniform the guidance concerning the reporting of related entities in the following AICPA publications:
  - Industry Audit Guides *Audits of Voluntary Health and Welfare Organizations* and *Audits of Colleges and Universities*
  - Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*
  - SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*[3]

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[1] *Consolidation* of a parent and subsidiary organizations requires the presentation of a single set of amounts for the entire reporting entity. *Combination*, as discussed in paragraphs 22 and 23 of Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, refers to financial statements prepared for organizations among which common control exists but for which the parent-subsidiary relationship does not exist. Both consolidation and combination require elimination of interorganization transactions and balances. This SOP provides no guidance concerning commonly controlled not-for-profit organizations.

[2] As discussed in appendix C, the Financial Accounting Standards Board (FASB) has on its agenda a project on consolidations and related matters. One of the phases of that project concerns financial reporting guidance for not-for-profit entities.

[3] SOP 78-10 has no effective date. This SOP amends, but does not affect the status of, SOP 78-10.

- Does not apply to entities or activities that are covered by the AICPA Industry Audit Guide *Audits of Providers of Health Care Services*

Conclusions

3. This SOP provides guidance for reporting (*a*) investments in for-profit majority-owned subsidiaries, (*b*) investments in common stock of for-profit entities wherein the not-for-profit organization has a 50 percent or less voting interest, and (*c*) financially interrelated not-for-profit organizations.

4. Whether the financial statements of a reporting not-for-profit organization and those of one or more other entities should be consolidated, whether those other entities should be reported using the equity method, and the extent of the disclosure that should be required, if any, should be based on the nature of the relationships between the entities.

Investments in For-Profit Majority-Owned Subsidiaries

5. Not-for-profit organizations with a controlling financial interest in a for-profit entity through direct or indirect ownership of a majority voting interest in that entity should follow the guidance in ARB 51, as amended by FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, in determining whether the financial position, results of operations, and cash flows of the for-profit entity should be included in the not-for-profit organization's financial statements.

Investments in Common Stock of For-Profit Entities Wherein the Not-for-Profit Organization Has a 50 Percent or Less Voting Interest

6. Investments in common stock of for-profit entities wherein the not-for-profit organization has 50 percent or less of the voting stock in the investee should be reported under the equity method in conformity with Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, if the guidance in that Opinion requires use of the equity method, subject to the exception in paragraph 7 of this SOP. Also, not-for-profit organizations should make the financial statement disclosures required by APB Opinion 18 if the guidance in that Opinion requires them.

7. Some AICPA audit guides applicable to some not-for-profit organizations permit investment portfolios to be reported at market value. Not-for-profit organizations that choose to report investment portfolios at market value in conformity with the AICPA audit guides may do so instead of applying the equity method to investments covered by paragraph 6 of this SOP.

Financially Interrelated Not-for-Profit Organizations

8. Not-for-profit organizations may be related to one or more other not-for-profit organizations in numerous ways, including ownership, *control*,[4] and *economic interest*.

9. As discussed in paragraphs 10–13, the various kinds and combinations of control and economic interest result in various financial reporting. Certain kinds of control result in consolidation (paragraph 10). Other kinds of control result in consolidation only if coupled with an economic interest (paragraph 11). Still other kinds of control result in consolidation being permitted but not required if coupled with an economic interest (paragraph 12). The existence of control or an economic interest, but not both, is discussed in paragraph 13.

10. Not-for-profit organizations with a controlling financial interest in another not-for-profit organization through direct or indirect ownership of a majority voting interest in that other not-for-profit organization should consolidate that other organization, unless control is likely to be temporary or does not rest with the majority owner, in which case consolidation is prohibited, as discussed in paragraph 13 of FASB Statement No. 94.

11. In the case of (*a*) control through a majority ownership interest[5] by other than ownership of a majority voting interest, as discussed in paragraph 10, or control through a *majority voting interest in the board of the other entity* and (*b*) an economic interest in other such organizations, consolidation is required, unless control

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[4] Words or terms defined in the Glossary are in italicized type the first time they appear in this SOP.

[5] Ownership of not-for-profit organizations may be evidenced in various ways because not-for-profit organizations may exist in various legal forms, such as corporations issuing stock, corporations issuing ownership certificates, membership corporations issuing membership certificates, joint ventures, and partnerships, among other forms.

is likely to be temporary or does not rest with the majority owner, in which case consolidation is prohibited, as discussed in paragraph 13 of FASB Statement No. 94.[6]

12. Control of a separate not-for-profit organization in which the reporting organization has an economic interest may take forms other than majority ownership or voting interest; for example, control may be through contract or affiliation agreement. In circumstances such as these, consolidation is permitted but not required, unless control is likely to be temporary, in which case consolidation is prohibited, as discussed in paragraph 13 of FASB Statement No. 94. If the reporting organization controls a separate not-for-profit organization through a form other than majority ownership or voting interest and has an economic interest in that other organization, and consolidated financial statements are not presented, the notes to the financial statements should include the following disclosures:

- Identification of the other organization and the nature of its relationship with the reporting organization that results in control
- Summarized financial data of the other organization including—
  - Total assets, liabilities, net assets, revenue, and expenses
  - Resources that are held for the benefit of the reporting organization or that are under its control
- The disclosures set forth in FASB Statement No. 57, *Related Party Disclosures*

13. In the case of control and an economic interest, the presentation of consolidated financial statements, as discussed in paragraph 11, or the disclosures, as discussed in paragraph 12, are required. The existence of control or an economic interest, but not both, precludes consolidation, except as stated in the next sentence, but requires the

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[6] Interests by not-for-profit organizations in other not-for-profit organizations may be less than complete interests. For example, a not-for-profit organization may appoint 80 percent of the board of the other not-for-profit organization. If the conditions for consolidation in this SOP are met, the basis of that consolidation would not reflect a minority interest for the portion of the board that the reporting not-for-profit organization does not control, because there is no ownership interest other than the interest of the reporting not-for-profit organization. However, some not-for-profit organizations may enter into agreements with other entities, such as sharing revenue from fund-raising campaigns, resulting in liabilities to those other entities. In such circumstances, those liabilities should be reported.

disclosures set forth in FASB Statement No. 57.[7] Entities that otherwise would be prohibited from presenting consolidated financial statements under the provisions of this SOP, but that currently present consolidated financial statements in conformity with the guidance in SOP 78-10, may continue to do so.

14. If consolidated financial statements are presented, they should disclose any restrictions made by entities outside of the reporting entity on distributions from the controlled not-for-profit organization to the reporting organization and any resulting unavailability of the net assets of the controlled not-for-profit organization for use by the reporting organization.

Effective Date and Transition

15. This SOP is effective for financial statements issued for fiscal years beginning after December 15, 1994, except for not-for-profit organizations that have less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date shall be for fiscal years beginning after December 15, 1995. Earlier application is permitted. For organizations that adopt FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, prior to its effective date, earlier application of this SOP is encouraged. Comparative financial statements for earlier periods included with those for the period in which this SOP is adopted should be restated.

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[7] The existence of an economic interest does not necessarily cause the entities to be related parties, as defined in FASB Statement No. 57. However, the disclosures required by that Statement also are required under this SOP if an economic interest exists.

Appendix B

Financial Accounting Series Preliminary Views on Consolidation Policy

INTRODUCTION

1. On September 10, 1991, the FASB issued a Discussion Memorandum, *Consolidation Policy and Procedures.*[1] That Discussion Memorandum analyzed basic issues related to determining which business corporations should be included in consolidated financial statements and which procedures should be used in preparing consolidated financial statements. Approximately 100 letters of comment were received in response to the Discussion Memorandum.

2. After considering the issues and the responses received, the Board has developed preliminary views on the basic issue of which entities should be included in consolidated financial statements and has decided to expose those views for public comment. The Board has not yet reached conclusions on the procedures to be used in preparing consolidated financial statements and intends to resume its deliberations on those procedures during the comment period on this Preliminary Views. It plans to issue an Exposure Draft of a Statement of Financial Accounting Standards for both consolidation policy and consolidation procedures after concluding those deliberations, considering comments received on this Preliminary Views, and redeliberating consolidation policy.

3. The views expressed in this Preliminary Views would apply to partnerships, trusts, and not-for-profit organizations as well as to business corporations, which were the only type of entities discussed in the 1991 Discussion Memorandum. Present standards issued by the FASB and its predecessors for consolidation policy are primarily directed at and limited to business enterprises formed as stock corporations; however, the basic issue of which entities should be included in consolidated financial statements is not limited to those corporations. The Board believes that developing a consolidation policy that can be applied to all entities and that focuses on the economic substance of relationships among organizations rather than their legal form would result in a significant improvement in practice.

4. Because of the significance of consolidation policy, the Board is issuing this Preliminary Views to solicit written comments from interested individuals and groups, including those that may not have responded to the Discussion Memorandum. The Board also expects that the related concept of control will be particularly useful in addressing issues in other phases of the consolidations and related matters project (paragraph 69). Thus, the Board is especially interested in comments about the understandability of the definition of control including the explanatory information and whether it can be applied with reasonable consistency. Responses will be most useful if they include the underlying reasons and the supporting evidence for the views expressed. The deadline for comments is December 31, 1994.

PRELIMINARY VIEWS

Scope

5. The proposed consolidation requirements would apply to business enterprises and not-for-profit organizations that control other entities regardless of the legal form of the controlling entity or the controlled entities. The proposed requirements would amend Accounting Research Bulletin No. 51, *Consolidated Financial Statements,* and FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries.* However, this Preliminary Views does not address combined financial statements and would not amend paragraphs 22 and 23 of ARB 51.

6. This Preliminary Views does not address the reporting of interests in trusts established for purposes of effecting an in-substance defeasance under the provisions of FASB Statement No. 76, *Extinguishment of Debt,* or interests in employee benefit trusts subject to the provisions of FASB Statement No. 87, *Employers' Accounting for Pensions,* No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions,* or No. 112, *Employers' Accounting for Postemployment Benefits.* Matters related to Statement 76 are being considered as part of a separate project on financial instruments. Statements 87, 106, and 112 address complex issues and resulted in relatively recent and significant changes in practice. The Board is aware of no compelling reasons to revisit those issues at this time.

Overview

7. The proposed requirements can be summarized as follows:

> A controlling entity (parent) shall consolidate all entities that it controls (subsidiaries) unless control is temporary at the time that entity becomes a subsidiary. For purposes of this requirement, control of an entity is power over its assets—power to use or direct the use of the individual assets of that entity to achieve the objectives of the controlling entity.

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[1] Appendix A discusses the background and reasons for this project.

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8. The concept of control for purposes of consolidated financial statements is the same for both business enterprises and not-for-profit organizations. However, differences in the organizational characteristics of business enterprises and not-for-profit organizations are likely to affect significantly the application of the concept of control in practice.

9. The factors to be considered in determining the existence of and identifying a controlling entity vary based on differences in legal form. Business corporations are usually organized as stock corporations, and ownership of voting shares is usually the most important factor in identifying a controlling entity. Not-for-profit organizations, however, are often nonstock corporations without shares or voting interests. Consequently, other factors such as the power to appoint members of the governing board or provisions in the corporation's charter or bylaws become important in determining the existence of and identifying a controlling entity. Determining the existence of a controlling entity of partnerships and trusts, whether organized by business enterprises or not-for-profit organizations, also involves issues different from corporations. Although there may be no voting interests in partnerships or trusts in the same sense as a voting interest in a corporation, application of the definition of control is the same in all cases.

10. The restrictive phrase *to achieve the objectives of the controlling entity* in the definition of control provides for consideration of differences in objectives between business enterprises and not-for-profit organizations that may be relevant to their financial reporting. For example, the individual assets of a charitable foundation may be usable to achieve the objectives of a controlling not-for-profit organization by providing goods or services to the controlling organization's constituents, but because of restrictions imposed by U.S. tax law the assets of a foundation sponsored by a business enterprise may not be usable to provide future net cash inflows to the owners of the sponsoring entity.

11. The remainder of this Preliminary Views discusses the Board's preliminary views on the nature of consolidated financial statements, the meaning of control, the effects of restrictions on control, control of corporations and partnerships, temporary control, relationships that do not involve control over individual assets, and control of special-purpose entities. Appendix A discusses the background of and reasons for this project. Appendix B includes illustrations of the application of the proposal in some specific situations. Appendix C includes consolidation policy discussions from ARB 51, as amended by Statement 94, and AICPA Statement of Position 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*.

The Nature of Consolidated Financial Statements

12. Consolidated financial statements present, primarily for the benefit of the shareholders, creditors, and other resource providers of the parent, the financial position, results of operations, and cash flows of a reporting entity that comprises a parent and its subsidiaries. The tie that binds different legal entities into a single reporting entity is control. Control of an entity is power over its assets—power to use or direct the use of the individual assets of an entity to achieve the objectives of the controlling entity. It is an exclusionary power—if A controls B, no other entity can. Most corporations, partnerships, and other entities are not subsidiaries of another corporation or partnership because they are not controlled by a single entity.

13. The definition of an asset in paragraph 25 of FASB Concepts Statement No. 6, *Elements of Financial Statements*, supports control of individual assets of another entity as the criterion for determining whether different legal entities are part of a single reporting entity. Assets are "probable future economic benefits[2] obtained or controlled by a particular entity as a result of past transactions and events" (footnote reference omitted). Paragraph 26 states ". . . legal enforceability of a claim to the benefit is not a prerequisite for a benefit to qualify as an asset if the entity has the ability to obtain and control the benefit in other ways." One of the "other ways" in which a particular entity controls a future economic benefit is by controlling the entity that has the asset that embodies the benefit. The controlling entity controls the individual assets of the controlled entity, and the two legal entities form a reporting entity whose individual

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[2] Paragraph 28 of Concepts Statement 6 adds that future economic benefit eventually results in net cash inflows to a business enterprise or the ability to provide needed or wanted goods or services to beneficiaries or other constituents of a not-for-profit organization, which often is the reason that resource providers donate to it. That paragraph also notes that the relationship between assets and net cash inflows to an entity is often indirect in both business enterprises and not-for-profit organizations. The ability to use a subsidiary's assets for a particular purpose need not be evidenced by a current cash flow to the parent.

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assets all qualify as assets of the reporting entity, and are reported in its consolidated statement of financial position. The parent's share of the equity interest (as opposed to voting interest) in a subsidiary is not a determining factor in the subsidiary's status as part of the reporting entity because the parent can obtain future economic benefits from the assets of its subsidiary in many ways, both directly through its equity interest and indirectly through its power over the assets.

14. The reporting entity reports the liabilities of both the subsidiary and the parent because the assets of each legal entity are subject to its liabilities—the liabilities constitute claims against the assets that take priority over the claims of the residual interest holders. Therefore, the obligations are liabilities of the reporting entity. The reporting entity reports the other financial statement items of both the parent and the subsidiary (revenues, expenses, and other items) because those items result from changes in its assets or liabilities or both. Failure to include the assets, liabilities, and changes in the assets and liabilities of the subsidiary would result in an incomplete representation of the financial position, results of operations, and cash flows of the reporting entity.[3]

15. Entities other than the parent that have a residual interest in a subsidiary are called noncontrolling interests. The reporting entity reports the noncontrolling interests' share of the equity of the subsidiary because, like other shareholders, the noncontrolling interests have an equity interest in the net assets of the reporting entity. The rights of the noncontrolling interests differ from the rights of the parent's shareholders in that the former have an interest in only a certain portion of the net assets of the reporting entity whereas the latter have an interest in all of the net assets of the reporting entity. The rights of the noncontrolling interest to dividends that might be declared and paid from earnings of the subsidiary are similar to those of holders of stock issued by the parent that pays dividends based on the earnings of a particular component of the reporting entity. The noncontrolling interests' share of the results of operations of the subsidiary are attributed to the equity of the noncontrolling interests.

The Meaning of Control

16. Control of an entity is power over its assets—power to use or direct the use of the individual assets of an entity to achieve the objectives of the controlling entity. Specific objectives of individual entities vary, but both business enterprises and not-for-profit organizations achieve their objectives by obtaining and processing resources and by distributing the resulting goods and services. Resources or assets are the lifeblood of both business enterprises and not-for-profit organizations, and their resource processing and distributing activities are not only the means by which they provide goods and services to members of society but also the reason they obtain, through exchanges or gifts, the cash and other assets with which to buy the goods and services they need to carry out those activities. For purposes of this definition, the objectives can be summarized by focusing on the indicators of their success—the objective of a business enterprise is to provide net cash inflows to its owners by enhancing the value of the enterprise or by distributing cash or other assets to its owners, and the objective of a not-for-profit organization is to provide needed goods or services to its beneficiaries or other constituents.

17. In business enterprises the factor that distinguishes a controlled entity from an investment in which the investor has at most an ability to influence decisions about the investee's assets is the ability of the parent to use or direct the use of the individual assets of the subsidiary in ways that increase the parent's own net asset value or the net cash inflows to its owners. Control, as distinguished from other types of decision-making authority, enables a controlling entity to use the individual assets under its control in ways that are intended to maximize the benefits to the controlling entity. The same factor applies to investments by not-for-profit organizations. In not-for-profit organizations, control, as distinguished from other types of decision-making authority, enables a controlling entity to use the individual assets of the controlled entity in ways that are intended to maximize the controlling entity's ability to fulfill its mission.

18. Control enables a parent to:

a. Direct the use of the assets of a subsidiary by establishing the controlled entity's capital and operating budgets and related policies. (Capital budgets include, among other things, financing through debt, equity, or contributions; acquiring assets for production or investment; selling or deploying assets for use, and distributing assets to owners. Operating budgets include acquiring resources other than capital resources and using or allocating all resources.)

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[3] Paragraphs 79 and 80 of FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, establish the importance of completeness in financial reporting. To report assets, liabilities, and the transactions and events that change them is a necessary part of completeness. To report a net interest in assets and liabilities of a controlled entity and the net change in that interest does not provide completeness in financial reporting.

b. Enforce its decisions by selecting, determining the compensation of, and terminating personnel responsible for implementing the decisions.

19. Control of a subsidiary also enables a parent to obtain future economic benefits in ways that are not available to holders of noncontrolling interests. Both controlling and noncontrolling shareholders receive direct benefits from their ownership of an equity interest in a business enterprise; however, in many cases, the parent can initiate actions to maximize its net cash inflows or service potential that do not necessarily result in proportionate benefits to noncontrolling shareholders. Some examples of ways in which the parent may indirectly maximize its future net cash inflows or service potential are by structuring transactions with its subsidiary to obtain necessary and scarce raw materials on a priority basis, at strategic locations, or at reduced costs of delivery; by gaining access to the subsidiary's distribution network, its patents, or proprietary production techniques; or by combining certain functions of the parent and the subsidiary to create economies of scale in management costs, employee benefits costs, or insurance costs, among others. Those benefits often are difficult, if not impossible, to quantify but they are real and valuable to the parent.

20. A controlling entity may delegate some of its powers to a manager or other entity or it may elect not to exercise its powers. Neither condition changes its status as a controlling entity.

Restrictions on Control

21. The powers of a controlling entity need not be unrestricted. In fact, unrestricted control rarely, if ever, exists. Control over a wholly owned entity with no debt is restricted by laws and regulations as well as by the nature of the entity's assets. Restrictions of that nature usually do not preclude the owner from exercising control.

22. Contractual restrictions on decision-making authority that can be removed by the decision maker's use of the resources of the entity do not deny control to the decision maker. For example, restrictions in debt or lease agreements are agreed to by a controlling entity, and the controlling entity generally can use the assets of the controlled entity to remove the restrictions by paying or refinancing the debt.

23. Fiduciary responsibilities to other owners may place some limit on a decision maker's power to determine the use of an entity's individual assets. An entity with decision-making authority over a corporation has a responsibility not to defraud the noncontrolling shareholders, a responsibility that, by itself, does not deny control to the decision maker. For example, if a parent wishes to withdraw assets from a corporate subsidiary through a dividend, it may be required to distribute a proportionate amount to noncontrolling interests (depending on the dividend rights of the various classes of stock), but a parent has no fiduciary responsibility to noncontrolling interests to use the subsidiary's assets in that way. The specific provisions of individual partnership agreements determine whether the responsibilities of a partner with authority to make certain decisions give it control of the partnership assets.

Corporations and Other Entities with Similar Governing Boards

The Nature of Control

24. Control of a corporation[4] is vested in the governing board by law and the corporate charter. Consequently, an entity with the direct or indirect ability to elect or appoint a majority of the members of a corporation's governing board[5] controls that corporation with rare exceptions. That ability may be attained in many different ways that fit into two general categories: legal control and effective control.

Legal Control

25. Control by a majority of voting rights is often called legal control. The controlling entity has the right under law to cast a majority of the votes at a meeting of shareholders through ownership of at least a majority of the voting stock or through a legal device without ownership of a majority voting interest. No level of cooperation among other shareholders would be sufficient to deprive an entity with legal control of its ability to cast a majority of the votes.

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[4] For convenience, this Preliminary Views uses the term *corporation* rather than the more accurate but unwieldy *corporations and other entities with similar governing boards*. The guidance in this section applies not only to corporations but also to entities in jurisdictions other than the United States that have elected or appointed governing boards with similar powers. It generally does not apply to trusts, even if they are administered by a board rather than an individual trustee. Trust agreements vary, but trustees' powers are usually much more limited than powers of governing boards of corporations.

[5] In some jurisdictions voting rights of members of the governing board may be unequal. In those jurisdictions the legal right to elect or appoint members with a majority of the voting power provides legal control.

26. The most clear-cut example of legal control is majority ownership in a corporation that issues only a single class of stock, but legal control may be obtained in other ways. A prominent example is pyramiding—having sequential tiers of subsidiary corporations each controlled through ownership of a majority of voting rights by a corporation in the next higher tier. In some pyramid structures, the controlling entity has only a small residual interest in the corporations in the lower tiers but nonetheless is able to control them.

27. Another example is ownership of a majority of voting rights without ownership of a majority of voting stock. That may be achieved through the use of more than one class of voting stock with disproportionate voting rights, such as (a) two classes of common stock with different voting rights or (b) a class of voting preferred stock that is entitled to a majority of voting rights.

28. A voting trust is yet another example of legal control. If the majority of the voting stock of a corporation is held by a trust, the right to vote that stock gives control without ownership of the stock. Some voting trusts are created voluntarily, for example, to unify control in family-controlled corporations. Others may result from legal actions by stockholders or creditors.

29. Situations in which one entity holds a majority of another entity's voting rights but does not have the power to control are rare. They include assignment of voting rights to another party, perhaps through a voting trust, legal actions such as bankruptcy, and certain circumstances in which another entity can unilaterally obtain control by exercising conversion rights or options.

30. Legal control of a corporation that does not issue stock is conferred by the legal right to appoint a majority of the members of that corporation's governing board. That right usually comes from provisions in the controlled corporation's charter or bylaws. It also may be indirect, that is, through legal control of a subsidiary that has legal control of another corporation.

Effective Control

31. Although the most clear-cut example of control of a corporation is the legal right to elect or appoint a majority of its governing board, control can be achieved in other ways. Control without that legal right is referred to as effective control. Most often it results from owning a large minority interest coupled with certain favorable circumstances. Although the means of achieving effective control differ from the means of achieving legal control, the result of being in control is the same. In all cases, control is defined as power to use or direct the use of the controlled entity's individual assets to achieve the objectives of the controlling entity.

32. Control through ownership of a large minority interest depends on the size of the interest and the extent of dispersion of the remaining interest or perhaps the disorganization or apathy of the remaining shareholders. The larger the minority interest or the more dispersed, disorganized, or apathetic the remaining shareholders, the more likely it is that the owner of the large minority interest is in control.

33. In some corporations, the owner of a large minority interest can expect to, and is able to, cast a majority of the votes simply because not all shareholders exercise their right to vote. Control through minority ownership often results from control of the proxy solicitation process of a corporation, however, and therefore control is much easier to maintain than to achieve. Once the holder of a large minority interest has been able to elect its nominees to the board of directors, subsequent elections and shareholder proxy activities normally are dominated by the incumbent directors or the incumbent management that is selected by the directors. The nominees for directors will be proposed in proxy statements with a request that shareholders give their proxy to the board or management to vote for those nominees. Many shareholders respond by giving their proxy, thereby perpetuating the effective control by the large minority shareholder.

34. In concept, the actual exercise of a particular prerogative of control, such as election of a majority of a subsidiary's board of directors, is not necessary for control to exist, provided that the ability to take that action is present. However, the holder of a significant minority interest (larger than any other single holding) may or may not be able to exercise control, and its ability to control may not be determinable except by assessing the extent to which that party actually exercises control. For example, actual election of a majority of a corporation's board of directors by the exclusive action of the holder of a large minority interest provides convincing evidence of that party's ability to control. The phrase *exclusive action* contemplates an ability to act without making concessions to gain the cooperation or acquiescence of others. Direction of a corporation's activities by a party whose ability to do so depends on the cooperation of another party or a small group of other parties is not control.

35. Governing boards of not-for-profit corporations may be self-perpetuating, that is, they elect their own successors. If so, no entity can have the ability to appoint or elect

the members directly, but an entity may be able to achieve the same result indirectly. For example, one not-for-profit organization may establish another and name its officers or board members as the initial board of the new corporation. The creating entity may be able to elect future board members through its influence on the existing board members.

Presumptions of Effective Control

36. Identifying effective control requires evaluation of individual facts and circumstances. Management of an entity is in the best position to accumulate the necessary information and judge the entity's ability to exercise effective control of other entities. However, certain circumstances make the presence of effective control highly probable, and if any of those circumstances exist, one entity should be presumed to have effective control of another in the absence of significant evidence to the contrary. Those circumstances are:

a. Ownership of a large minority voting interest (approximately 40 percent or more) in the absence of another party or organized group of parties with a significant interest (approximately 20 percent or more)
b. An ability demonstrated by a recent election to dominate the process of nominating candidates for an entity's governing board and to cast a majority of the votes cast[6] in an election of board members
c. A unilateral ability to obtain a majority voting interest without significant additional cash outlay, for example, through ownership of securities that may be converted into a majority voting interest at the option of the holder
d. Provisions in a corporation's charter or bylaws that cannot be changed by entities other than its creator (or through legal due process) and that limit the corporation to activities that can be initiated or were scheduled by the creating entity and are designed primarily to provide future net cash inflows or other future economic benefits to its creator.

37. Effective control of a corporation is usually evidenced by an ability to elect or appoint a majority of the members of its governing board without the legal right to do so. Presumptions (a) and (b) involve circumstances of that type. However, a corporation may be effectively controlled in other ways. Presumptions (c) and (d) involve control without the current ability to elect or appoint members to a governing board.

38. Presumption (c) involves the ability to take control at will in the future without significantly increasing an investment in the entity. Control must be assessed at the balance sheet date to determine whether to include an entity in consolidated financial statements, and the ability to obtain control in the future does not necessarily constitute current control. However, if that ability comes from a unilateral legal right that requires no further commitment of resources, the current decision maker must consider the interests of the entity that can take control. If the entity with the unilateral ability to take control is determined to have effective control of a corporation, no other entity can control that corporation even if it presently has legal control.

39. Presumption (d) involves control through restrictions on a corporation's activities in its charter or bylaws. Corporate charters are usually designed to allow maximum flexibility in the corporation's activities, but a creating entity can write a charter or bylaws to restrict a corporation's activities and thus predetermine its own control even though it holds only a small, or even no ownership interest. Predetermined control may be an effective way to achieve and maintain control of corporations with self-perpetuating boards, particularly not-for-profit organizations.

40. Circumstances that lead to presumptions of control leave little doubt about one entity's ability to control another. Control is presumed unless there is clear and overriding evidence to the contrary. The specific evidence required to overcome a presumption varies depending on the specific presumption and the surrounding circumstances. For example, the presumption of an ability to elect a majority of a corporation's directors with a large minority voting interest would be overcome if the holder's nominees were actually defeated in an election of board members but not because the holder had chosen not to vote in an election or because the holder was uncertain about its ability to maintain control.

Indicators of Effective Control

41. Effective control may exist in circumstances other than those that result in a presumption of control. Management of an entity has access to the information necessary to determine whether control exists and a responsibility to assess whether the entity controls any other entity in which it has an investment or other relationships that give it the right to future economic benefits. Management should pay particular attention to that assessment if

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[6] This should not be confused with legal control achieved by the right to cast a majority of the votes eligible to be cast. In many elections of directors, not all eligible votes are actually cast. Usually, 50 percent of the eligible votes must be represented at a stockholders' meeting to constitute a quorum. If exactly 50 percent of the eligible votes were represented at the meeting, the holder of a voting interest of 25 percent plus 1 vote could cast a majority of the votes.

there are indicators that control has been or can be exercised. If such indicators exist, management should carefully assess the possibility that it is in control of the individual assets of another entity. Some indicators of possible effective control are:

a. An ability to cast a majority of the votes cast in an election of directors
b. An ability to use the resources of a corporation to control the process of nominating members of an entity's governing board and to solicit proxies from other shareholders
c. An ability to appoint members of a corporation's governing board to fill vacancies until the next election
d. A right to a majority of the net assets of a corporation in the event of liquidation or to a majority of net assets in a distribution other than a liquidation
e. A business or charitable purpose of one corporation that is integrated with the business or charitable purpose of another entity, for example, an organization formed for the primary purpose of (1) holding and investing assets to generate income for another entity, (2) holding assets to pay the debts of another entity, or (3) raising contributions for a specific charitable organization (The lack of integrated businesses or charitable purposes does not necessarily indicate lack of control.)
f. Retention of a minority voting interest in an entity after previously holding a majority voting interest (If the level of voting interest is approximately 40 percent or more, a presumption of control may apply.)
g. Beneficial contractual relationships with an entity that continue after previously holding a majority voting interest
h. A continuing ability to appoint some members of the governing board of a corporation for which majority appointment or election powers previously existed
i. Ownership of an option to acquire a majority or large minority voting interest that requires the outlay of a significant amount of additional cash.

42. Indicators are intended to identify circumstances that often accompany control and increase management's level of attention to a relationship with a particular entity. Multiple indicators of control of a single entity generally indicate an increased likelihood that control exists. Careful consideration of the facts and circumstances is required when one or more indicators exist, but there is no presumption about the results of the investigation.

Partnerships and Other Entities without Governing Boards

The Nature of Control

43. Unlike corporations, partnerships[7] do not necessarily have governing boards. The partnership agreement and the related law must be carefully considered to determine whether control rests with a single partner.

44. A partnership, as defined in the *American Heritage Dictionary,* involves sharing of decision-making authority, which implies that no single partner is in control. Under partnership law, however, a partnership can include almost any division of decision-making authority to which the partners agree. The authority of controlling entities and the factors that restrict decision-making authority discussed above must be considered. If a partner can unilaterally determine the capital and operating budgets and related policies and can select, compensate, and terminate the personnel who implement the decisions, that partner is in control. If two or more partners who are unaffiliated must jointly agree on those decisions, no single partner is in control. Difficulties in determining the existence of control arise in two situations: (a) one partner has decision-making authority but others either must approve or can veto the decisions and (b) one partner has decision-making authority but the partnership agreement narrowly defines the available choices for the use of individual assets.

Factors in Determining Control

45. Individual facts and circumstances must be considered to determine whether control exists if the decision maker's power is significantly restricted by other partners' rights or by a tightly written partnership agreement. That determination is especially difficult for limited partnerships. In the United States, a general partner is the primary decision maker because of tax law considerations and limited partnership law but may or may not control the partnership. The following should be considered in determining whether a general partner controls a limited partnership:

a. If there are two or more unaffiliated general partners, they most likely make joint decisions, and no one partner is in control.

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[7] For convenience, this Preliminary Views uses the term *partnerships* rather than the more accurate but unwieldy *partnerships and other entities without governing boards.* The guidance in this section applies not only to partnerships but also to similar entities in jurisdictions other than the United States that do not have governing boards or whose governing boards do not have legal authority similar to corporations.

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b. If the general partner develops and recommends the operating and capital budgets but the limited partners must approve those budgets, the general partner is not in control.
c. If the limited partners have the right to remove the general partner for other than violations of law, the general partner is not in control.
d. If the general partner can amend the partnership agreement unilaterally, the general partner has the ability to remove any restrictions and is in control.

46. The effect of restrictions on the general partner's power to use the individual assets of the partnership to attempt to generate net cash inflows for itself or one or more of its controlled entities or to provide goods or services to beneficiaries or other constituents must be evaluated based on specific circumstances. A restriction that appears to deny control to a general partner may not do so if the limited partners' rights are so difficult to exercise that the probability of their taking action is remote, for example, if there is a large number of limited partners and a unanimous vote of the limited partners is required.

Temporary Control

47. A controlling entity should consolidate entities that it controls unless that control is temporary at the time it is obtained (paragraph 7). An assessment of whether control is temporary should be based on circumstances that exist at the date an entity becomes a subsidiary, and once consolidated, a subsidiary should continue to be consolidated until the parent ceases to control it. Control of a new subsidiary should be considered temporary if at the time it is obtained the parent is obligated to relinquish control within a certain period of time or if the parent has otherwise relinquished control before the balance sheet date for financial statements that are for the period that control was obtained. For example, control is temporary if an investor is required by antitrust laws or regulatory authorities to relinquish control of a newly acquired subsidiary or if it obligated itself through contractual agreements to sell certain subsidiaries in a newly acquired group.

Relationships That Do Not Result in Control over Individual Assets

48. The following paragraphs describe relationships that are sometimes characterized as control of one entity by another. However, under the definition of control in this Preliminary Views, these types of relationships generally are not relationships between a controlling and a controlled entity and will not result in consolidated financial statements.

49. *Managers and managed entities*—A manager may direct the use of another entity's assets and receive a fee for its services. The manager usually does not control the managed entity because its authority has been delegated to it by the entity in control and may be withdrawn at its discretion and because the use of the assets under management is not directed toward the objectives of the manager.

50. *Mutual funds and fund managers*—The manager of an open-end mutual fund decides how to invest the fund's assets but cannot obtain and control the future economic benefits of those investments. Paragraph 30 of Concepts Statement 6 states that "assets other than cash benefit an entity by being exchanged for cash or other goods or services, by being used to produce goods or services or otherwise increase the value of other assets, or by being used to settle liabilities." Paragraph 184 adds that the entity with an asset is the one that within the limits set by the nature of the benefit or the entity's right to it can exchange the asset, use it to produce goods or services, exact a price for others' use of it, use it to settle liabilities, hold it, or perhaps distribute it to owners. A parent can use the individual assets of a subsidiary to do one or more of these things and can benefit from doing so. A fund manager cannot use the assets of the fund to do any of those things to benefit itself. For example, the Investment Company Act of 1940, as amended, provides that the investment advisor of a mutual fund or other management investment company has a fiduciary responsibility to protect the interests of the investors in the fund. That responsibility combined with other restrictions that the Act places on the investment advisor precludes it from controlling the fund. It can only receive compensation for the services that it provides to investors in the fund.

51. *Trusts, trustees, and beneficiaries*—A trustee holds title to the assets in a trust and may have custody, but the trust assets generally are not the trustee's assets. The trustee makes decisions about investing the assets of the trust for the benefit of the holders of the beneficial interest but, like the mutual fund manager, cannot obtain the benefits represented by those assets for itself. Rather, the

trustee is paid for services that it provides, which may be based on the value of the trust assets or changes in them. That depends on how compensation is specified in the trust instrument.

52. Trust agreements vary, but beneficiaries usually have an interest in the trust as a whole and do not control its individual assets. That kind of interest or relationship generally does not result in control of one entity by another; however, unconditional rights to receive future cash flows from trusts usually are recognizable assets.

53. *Grant-making foundations and their sponsors*—Some business enterprises prefer to create and use grant-making foundations to carry out their charitable goals rather than make contributions through a corporate-administered giving program. Those foundations may be formed as not-for-profit corporations or as trusts to promote social, educational, religious, or other charitable activities. Company-sponsored foundations generally remain closely tied to the company that creates and funds them with annual contributions. A majority of the directors or trustees of a foundation often are officers and directors of the sponsoring company or are otherwise appointed by the company, thus, enabling the company to dictate the foundation's operating, investing, and financing policies.

54. However, U.S. tax law imposes significant limits on foundations and their directors that preclude a sponsoring company from deriving future economic benefits (or net cash inflows) from foundation assets, from contributions to the foundation, or from other transactions or activities involving the foundation. Because of the limits, the decision-making and custodial powers of the directors of a company-sponsored grant-making foundation established as a not-for-profit corporation may be similar to the powers of trustees of a trust established for the benefit of others. Because the foundation's assets must be used exclusively for charitable purposes that benefit others, a business enterprise cannot, through the powers of its appointed directors, use or direct the use of foundation assets to benefit its owners or otherwise directly enhance the value of the enterprise.

55. *Franchisers and franchisees*—A franchiser grants rights to use its name, products, processes, or other items to a franchisee for a fee. The franchise agreement also may impose limits on the franchisee's rights to deviate from certain standards. Although franchise agreements may vary, the franchiser usually does not have power over the individual assets of the franchisee. The franchiser has the conditional right to terminate the franchise agreement if the franchisee does not comply with its terms, but the franchisee continues to control its own assets and can continue to operate (without the rights granted by the franchiser) even if the franchise agreement is terminated.

56. *Federations, membership organizations, or other associations and their members*—Two or more entities having common or similar purposes may unite, associate, or otherwise join together to carry out certain common objectives. For example, local and regional nonprofit corporations sometimes join an associated group or create a national organization (federation). Like franchisees, the local organizations may, in exchange for certain membership rights and privileges (for example, centralized management, fund raising, investing, or public education programs or messages), agree to operate under a common name and be bound by certain standards and policies of the national organization, but the national organization usually has no power over the individual assets of the local organizations. Like franchisers, the national organization may have a conditional right to terminate the agreement if the local organization does not comply with its terms, but the local organization continues to control its assets and can continue its operations even if the agreement is terminated precluding further use of the common organization name.

57. Similarly, religious organizations also may unite, associate, or otherwise join together to carry out their mission. For example, local congregations (such as a church or parish) often join or otherwise affiliate with a judicatory (such as a diocese, presbytery, synod, or annual conference) that may prescribe certain beliefs and practices of members of the congregation. The judicatory may have the right to ratify or confirm the election of members of the governing board of a local congregation; however, they often do not have the right to nominate those members. The judicatory also may have conditional rights to remove board members for violations of the prescribed beliefs or practices. Nonetheless, a judicatory usually is not able to establish a congregation's operating and capital budgets or otherwise direct how the individual assets of the congregation are used. Rather, as protection against undue judicatory interference, denominational rules and

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policy usually establish a congregation as an entity in its own right with certain rights and protections that can be upheld in ecclesiastical courts or similar denominational processes, as well as in civil courts.

58. *Lenders and borrowers*—A lender may restrict the controlling entity's decision-making authority by preventing certain actions, such as sales of assets pledged as security on a loan. The lending agreement also may allow the lender to initiate sales of pledged assets or other actions if the borrower defaults. The lender's power to sell assets of the borrower is conditional and limited to specified assets in which it has a security interest. The right to prevent a sale gives the lender the ability to protect its conditional interest but not the power to use the asset. Control is the power to initiate actions, not merely to thwart certain actions of others. Thus, the assets of the borrower are not assets of the lender.

Control of Special-Purpose Entities

59. Sometimes, one entity (the "sponsor") creates or causes to be created an entity to achieve a particular objective and may or may not retain an investment or other interest in the entity. Contracts with the entity or provisions in the legal document that establishes the entity may limit its activities to those that are intended to achieve the particular purpose for which it was established. An entity of that type is often referred to as a special-purpose entity or special-purpose vehicle. Special-purpose entities are often used to facilitate leasing transactions or securitization of receivables, but they have many other possible uses.

60. The definition of control in paragraph 16 applies to special-purpose entities whether they are established as corporations, partnerships, or trusts. The facts and circumstances surrounding the creation, ownership, objectives, and permitted uses of the assets of a special-purpose entity must be considered in the same way as for other entities. The guidance in paragraphs 24-42 applies to special-purpose corporations and paragraphs 43-46 to special-purpose partnerships.

61. Paragraph 36(d) may be particularly important in assessing control of a special-purpose corporation if the sponsor does not hold a majority voting interest. The entity that creates a special-purpose corporation is presumed to control it if provisions in the corporation's charter or bylaws cannot be changed by entities other than the creator (or through legal due process) and limit the corporation to activities that can be initiated or were scheduled by the creating entity and are designed primarily to provide future net cash inflows or other future economic benefits to its creator.

62. The notion of control and the presumption in paragraph 36(d) that applies to corporations are also relevant in assessing control of a special-purpose trust. As discussed in paragraph 51, relationships between a trust and a trustee or a trust and a beneficiary usually are not relationships between a controlling and a controlled entity because decision-making authority usually rests with a trustee who cannot direct the use of the individual assets to achieve its own objectives and because those who have an interest in the assets of the trust usually do not have decision-making authority over the individual assets. However, a control relationship may exist if, through the provisions of the trust agreement, the creator of a special-purpose trust limits the activities of the trust and powers of the trustee by prescribing that the individual assets be used in specific ways that are designed primarily to provide future net cash flows or other future economic benefits to its creator.

63. If the creating entity does not control the special-purpose entity and no entity holds a majority voting interest, an entity with the right to receive future cash flows or other future economic benefits from the special-purpose entity may control it. If the charter, bylaws, or partnership agreement gives a party with a beneficial interest the power to decide whether and when the special-purpose entity executes operating and capital transactions without permission or cooperation of other entities, that party is in control. If that party cannot initiate cash distributions and cannot make decisions about the individual assets, however, it is not in control. Control of that special-purpose entity may be shared by two or more parties.

ALTERNATIVE VIEW

64. One Board member disagrees that control alone is sufficient for one business enterprise to consolidate another business enterprise. Consolidated financial statements for a business enterprise are intended to serve primarily the needs of the shareholders of the parent. He believes that assets and liabilities of a controlled entity should be consolidated only in situations where the ultimate net cash inflow or outflow from those assets and liabilities inure substantially for the benefit of, or detriment to, investors in the parent. He would support consolidation of less-than-50-percent-owned controlled entities when because of the presence of control the parent has the ability to structure transactions entered into by the controlled entity in such a way as to derive future benefits beyond the level represented by its investment in the entity. That is, if the parent *in substance* is exposed to the majority of that entity's ultimate net cash flows, he would

consolidate the entity. Otherwise, he believes that the equity method of accounting for an investment in a controlled entity combined with disclosure in notes to the parent's financial statements provides a better basis for assessing the probable amounts and timing of future net cash inflows to investors in the parent company.

65. That Board member acknowledges that ARB 51 as amended by Statement 94 requires consolidation in certain situations in which the parent has legal voting control but has substantially less than a 50 percent equity interest, for example, in a multitiered (pyramid) organization where each successive "parent" owns slightly more than a 50 percent interest. However, he would not amend Statement 94 in this regard because consolidation based on a controlling voting interest has been accepted practice for business corporations for many years, and there has not been a perceived need from users of financial statements for a change.

66. That Board member would not extend the requirements of ARB 51 as amended to partnerships or most other business enterprises not already affected. Thus, he specifically objects to the requirement to consolidate a limited partnership that is controlled by a general partner that has a small equity interest except where other arrangements (for example, rights to proceeds from asset sales beyond those represented by its equity interest) give the general partner the major share of the ultimate net cash flows.

67. That Board member believes that the information needs of most providers of resources to not-for-profit organizations differ from those who provide resources to for-profit entities. In particular, he believes that most providers of resources to not-for-profit organizations do not assess the amount, timing, and uncertainty of cash flows to them. Therefore, he accepts the Board's preliminary views as they apply to not-for-profit entities.

Appendix C

Other Pertinent Rulings

Listed below are some other consolidation pronouncements that have important implications for independent colleges and universities. Business officers should familiarize themselves with these rulings, and are encouraged to obtain copies by writing to addresses provided.

Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (ARB No. 51, August 1959)

A copy of this bulletin can be obtained by writing to:

American Institute of Certified
Public Accountants
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

Financial Accounting Standards Board Statement of Financial Accounting Standards No. 94, *Consolidation of All Majority-Owned Subsidiaries* (SFAS No. 94, October 1987)

Financial Accounting Series Discussion Memorandum on Consolidation Policies and Procedures (FAS DM No. 107-A, September 1991)

Copies of both of these documents can be ordered through the following address:

Financial Accounting Standards Board
401 Merrit 7
P.O. Box 5116
Norwalk, CT 06856

Pronouncements Applicable to Public Institutions

Appendix D	**Governmental Accounting Standards Board Statement No. 14, *The Financial Reporting Entity***
Appendix E	**Governmental Accounting Standards Board Exposure Draft, *The Financial Reporting Entity — Affiliated Organizations***

Appendix D

Governmental Accounting Standards Board Statement No. 14, *The Financial Reporting Entity*

Statement No. 14 of the Governmental Accounting Standards Board

The Financial Reporting Entity

June 1991

INTRODUCTION AND BACKGROUND INFORMATION

Scope of This Statement

1. This Statement establishes standards for defining and reporting on the financial reporting entity. It also establishes standards for reporting participation in joint ventures. It supersedes the standards established by National Council on Governmental Accounting (NCGA) Statement 3, *Defining the Governmental Reporting Entity;* NCGA Statement 7, *Financial Reporting for Component Units within the Governmental Reporting Entity;* and NCGA Interpretation 7, *Clarification as to the Application of the Criteria in NCGA Statement 3, "Defining the Governmental Reporting Entity."* Those standards are generally included in the GASB *Codification of Governmental Accounting and Financial Reporting Standards* (May 31, 1990), Section 2100, "Defining the Reporting Entity"; Section 2600, "Reporting Entity and Component Unit Presentation and Disclosure"; and Section J50, "Joint Ventures."[1] In addition, this Statement amends all disclosure requirements in the Codification that relate to reporting by the "entity as a whole."

Background

2. GASB Concepts Statement No. 1, *Objectives of Financial Reporting,* states that "accountability is the cornerstone of all financial reporting in government" and "financial reporting plays a major role in fulfilling government's duty to be publicly accountable in a democratic society" (also cited in Codification Section 100, paragraph .156). It follows that an *accountability* perspective should provide the basis for defining the financial reporting entity. Financial reporting based on accountability should enable the financial statement reader to focus on the body of organizations that are related by a common thread of accountability to the constituent citizenry.

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[1] Further references to the Codification are abbreviated. For example, Section 2100, paragraph .103, would be Cod. Sec. 2100.103.

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3. The organizational structure of many governments has become increasingly complex. The demands placed on governments to provide services may outpace their legal, financial, or administrative ability to provide those services within the traditional framework of general purpose government. For this reason and others, many governments have created separate organizations. Whatever the reason for creation of those "separate" organizations, comprehensive financial reporting from a public accountability perspective requires determining which of these organizations should be included as part of a financial reporting entity.

4. Sometimes separate organizations are created because it is believed that debt backed by the revenue-generating capacity of a specific facility will be better accepted in the capital markets or because of the perceived greater efficiency of a separate corporate-style structure. In a separate organization, governing board and management efforts can be focused on one specific function instead of the myriad services often overseen by the management of a general purpose government.

5. Some state statutes or municipal corporate charters may specify the services to be provided or the functions to be performed by an individual local government. Instead of revising the charter or changing the statutes when there is a need to provide additional services to citizens, some local governments take advantage of other legal provisions that enable them to create separate organizations to provide the additional services that may not have been envisioned when the charter or statute was written.

6. In some instances, separate organizations have been created to overcome constitutional or statutory limitations on the issuance of debt. For example, separate financing corporations have been created by some governments to issue debt on the government's behalf that otherwise might not have been issued directly by the government because of limitations on the issuance of debt.

7. Many public authorities and special districts have a legal, financial, or administrative autonomy that departments and agencies may not have within the general government's organizational framework. Legal autonomy derives from the organization's corporate powers, including the ability to buy, sell, lease, and mortgage property in its own name and the power to sue and be sued without recourse to the state or municipality itself. Financial autonomy is manifested in an organization's capacity to support itself from revenues generated from separate taxes, fees, and

charges to the consumers of its goods or services. Administrative autonomy means freedom from some of the administrative controls over government programs and operations, such as civil service regulations and pay scales; central budgetary controls; regulations on contracting, purchasing, and rate setting; and the controls imposed by "pre-audits" often required of government agencies and departments.

8. Despite the outward appearance of autonomy, or separateness, these organizations customarily are administered by governing bodies that have been appointed by the elected officials of a primary government or by the primary government's officials serving ex officio. A primary government's officials are elected by the citizenry to serve as their representatives to promote the public health, safety, morals, education, general welfare, security, prosperity, and contentment of the citizens within its jurisdiction. Thus, the elected officials are accountable to those citizens for their public policy decisions, regardless of whether those decisions are carried out directly by the elected officials through the operations of the primary government or by their designees through the operations of specially created organizations. This broad-based notion of accountability by elected officials leads to the underlying concept of the governmental financial reporting entity: Governmental organizations are responsible to elected governing officials at the federal, state, or local level; therefore, financial reporting by a state or local government should report the elected officials' accountability for those organizations.

STANDARDS OF GOVERNMENTAL ACCOUNTING AND FINANCIAL REPORTING

Applicability of This Statement

9. The requirements of this Statement apply at all levels to all state and local governments. The Statement applies to financial reporting by **primary governments**,[2] governmental **joint ventures**, **jointly governed organizations**, and **other stand-alone governments**; and it applies to the separately issued financial statements of governmental **component units**. This includes governmental enterprises, public benefit corporations and authorities, public employee retirement systems, governmental utilities,

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[2] Terms defined in Appendix B, "Glossary," are printed in **boldface type** the first time they are used.

governmental hospitals and other healthcare providers, and governmental colleges and universities. In addition, this Statement should be applied to all governmental and nongovernmental component units when they are included in a governmental **financial reporting entity**. (See paragraphs 12, 43, 65, and 66 for an explanation of how organizations other than primary governments should apply this Statement.)

The Financial Reporting Entity Concept

10. The concept underlying the definition of the financial reporting entity is that elected officials are **accountable** to their constituents for their actions. Because one of the objectives of financial reporting is to provide users of financial statements with a basis for assessing the accountability of those elected officials, the definition of the financial reporting entity should be based on accountability. Because providing public services is, ultimately, the responsibility of elected officials, all governmental organizations are responsible to elected officials at the federal, state, or local level. Financial reporting by a state or local government should report the elected officials' accountability for those organizations.

11. The financial statements of the reporting entity should allow users to distinguish between the primary government and its component units by communicating information about the component units and their relationships with the primary government rather than creating the perception that the primary government and all of its component units are one legal entity. To accomplish this goal, the reporting entity's financial statements should present the fund types and account groups of the primary government (including its **blended** component units, which are, in substance, part of the primary government) and provide an overview of the **discretely presented** component units

Definition of the Financial Reporting Entity

12. As discussed in detail below, the financial reporting entity consists of (a) the primary government, (b) organizations for which the primary government is **financially accountable** (see paragraphs 21–37), and (c) other organizations for which the nature and significance of their relationship with the primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete (see paragraphs 39–41). The nucleus of a financial reporting entity usually is a primary government. However, a governmental organization other than a

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primary government (such as a component unit, a joint venture, a jointly governed organization, or another stand-alone government) serves as the nucleus for its own reporting entity when it issues separate financial statements. Although this Statement is written from the perspective of the primary government, its requirements apply to the separately issued financial statements of governmental component units, joint ventures, jointly governed organizations, and other stand-alone governments. These organizations should apply the provisions of this Statement as if they were a primary government.

Primary Governments

Definition of a Primary Government

13. The foundation of a primary government is a separately elected governing body—one that is elected by the citizens in a general, popular election. As the nucleus of the financial reporting entity, the primary government generally is the focal point for the users of the financial statements. Thus, it is important to define the primary government and determine what it comprises. A primary government is any state government or general purpose local government (municipality or county). A primary government is also a special-purpose government (for example, a school district or a park district) that meets all of the following criteria:

a. It has a separately elected governing body.
b. It is **legally separate** (see paragraph 15).
c. It is **fiscally independent** of other state and local governments (see paragraphs 16 – 18).

14. *A primary government consists of all the organizations that make up its legal entity.* All funds, organizations, institutions, agencies, departments, and offices that are not legally separate are, for financial reporting purposes, part of a primary government. If an organization is part of a primary government, its financial data should be included with the financial data of the primary government.

Determining Separate Legal Standing

15. An organization has separate legal standing if it is created as a body corporate or a body corporate and politic, or if it otherwise possesses the corporate powers that would distinguish it as being legally separate from

the primary government. Generally, corporate powers give an organization the capacity to have a name; the right to sue and be sued in its own name without recourse to a state or local governmental unit; and the right to buy, sell, lease, and mortgage property in its own name. The corporate powers granted to a separate organization are enumerated in its corporate charter or in the legislation authorizing its creation. A special-purpose government (or any other organization) that is *not* legally separate should be considered, for financial reporting purposes, part of the primary government that holds the corporate powers.

Determining Fiscal Independence or Dependence

16. A special-purpose government is fiscally independent if it has the ability to complete certain essential fiscal events without substantive approval by a primary government.[3] A special-purpose government is fiscally independent if it has the authority to do all three of the following:

a. Determine its budget without another government's having the authority to approve and modify that budget.
b. Levy taxes or set rates or charges without approval by another government.
c. Issue bonded debt without approval by another government.

A special-purpose government that is not fiscally independent is **fiscally dependent** on the primary government that holds one or more of those powers. A special-purpose government may be fiscally dependent on another state or local government regardless of whether it receives *financial* assistance from that state or local government; fiscal dependency does not necessarily imply that a **financial benefit** or **burden** relationship exists.

17. In determining whether a special-purpose government is fiscally independent, a distinction should be made between substantive approvals and ministerial (or compliance) approvals. Special-purpose governments typically are subject to the general oversight of their respective state governments, and sometimes to the oversight of county or other local gov-

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[3] There may be instances in which a primary government is temporarily placed under the fiscal control of another government; for example, a state may obtain direct, temporary fiscal oversight over a school district. A primary government that is temporarily under the fiscal control of another government continues to be fiscally independent for purposes of this Statement.

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ernments as well. Often, this general oversight responsibility includes an approval process that is more ministerial or compliance oriented than substantive. Examples of approvals that are likely to be ministerial or compliance oriented in nature rather than substantive are:

a. A requirement for a state agency to approve local government debt after review for compliance with certain limitations, such as a debt margin calculation based on a percentage of assessed valuation.
b. A requirement for a state agency, such as a department of education, to review a local government's budget in evaluating qualifications for state funding.
c. A requirement for a county government official, such as the county clerk, to approve tax rates and levy amounts after review for compliance with tax rate and levy limitations.

18. A special-purpose government subject to substantive approvals should not be considered a primary government for purposes of this Statement. For example, budgetary approval is substantive if a government has the authority to reduce or modify a special-purpose government's budget. On the other hand, a special-purpose government that is *statutorily prohibited* from incurring debt may be fiscally independent if it possesses the other two powers because the statutory prohibition does not subordinate the special-purpose government to another government for debt approval. It may be necessary to ascertain whether approvals or restrictions have the effect of impairing the special-purpose government's fiscal independence.

Reporting the Primary Government

19. The financial data of the primary government (and its blended component units as discussed in paragraphs 52–54) should be reported in accordance with the provisions of Codification Section 2200, "Comprehensive Annual Financial Report." This Statement does not modify fund reporting requirements referred to in that section. Regardless of entity considerations, a primary government should report its fiduciary funds according to Cod. Sec. 2200.106 and .111. For example, there may be organizations that do not meet the definition for inclusion in the financial reporting entity. They should, nevertheless, be reported as a fiduciary fund of the primary government if the primary government has a fiduciary responsibility for them. The financial data of governmental colleges and universities that are considered to be part of the primary government and

that apply the provisions of the American Institute of Certified Public Accountants Industry Audit Guide, *Audits of Colleges and Universities* (AICPA College Guide), should be included within the financial data of the primary government but may be presented separately from the fund types of the primary government. Rather than be reclassified and reported within the primary government's funds and account groups, the institution's balance sheet may be reported in a column separate from the fund types of the primary government, and its statement of changes in fund balances and statement of current funds revenues, expenditures, and other changes may also be presented in separate statements.

Component Units

Definition of Component Units

20. Component units are legally separate organizations[4] for which the elected officials of the primary government are financially accountable (as discussed in paragraphs 21–37). In addition, component units can be other organizations for which the nature and significance of their relationship with a primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete (as discussed in paragraphs 39–41).

Financial Accountability

21. Accountability flows from the notion that individuals are obliged to account for their acts, including the acts of the officials they **appoint** to operate governmental agencies. Thus, elected officials are accountable for an organization if they appoint a voting majority of the organization's governing board. Sometimes, however, appointments are not substantive; other governments (usually at a lower level) may have oversight responsibility for those officials. This Statement uses the term *financial accountability,* rather than *accountability,* to describe the kind of relationship warranting the inclusion of a legally separate organization in the reporting entity of another government. The following circumstances set forth a primary government's financial accountability for a legally separate organization.

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[4] A component unit may be a governmental organization (except those that meet the definition of a primary government in paragraph 13), a nonprofit corporation, or a for-profit corporation.

a. The primary government is financially accountable if it appoints a voting majority of the organization's governing body[5] *and* (1) it is able to **impose its will** on that organization (paragraphs 25 – 26) *or* (2) there is a potential for the organization to provide specific financial benefits to, or impose specific financial burdens on, the primary government (paragraphs 27 – 33).

b. The primary government may be financially accountable if an organization is fiscally dependent (paragraphs 16 – 18) on the primary government regardless of whether the organization has (1) a separately elected governing board, (2) a governing board appointed by a higher level of government, or (3) a jointly appointed board (paragraphs 34 – 38).

Appointment of a Voting Majority

22. If a primary government appoints a simple majority of the organization's governing board, it usually has a voting majority. However, if financial decisions require the approval of more than a simple majority, the primary government is not accountable for the organization.

23. For purposes of determining whether accountability exists, a primary government's appointment authority should be substantive. In some cases the appointment authority of a primary government's officials may be limited by a nomination process. For example, state statutes or local ordinances may require a primary government to select its appointees from a slate of candidates provided by one or more individuals or groups other than the primary government's officials or appointees. A primary government's appointment authority is not substantive if the number of candidates is severely limited by the nominating process, for example, if a primary government must select three appointees from a single slate of five candidates. Additionally, a primary government's appointment authority may not be substantive if its responsibility is limited to confirming appointments made by individuals or groups other than the primary government's officials or appointees.

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[5] This also includes situations in which a voting majority of the organization's governing body consists of the primary government's officials *serving as required by law* (and, thus, technically not *appointed* by the primary government).

24. In most instances, legal provisions for appointment of an organization's officials also provide for continuing appointment authority. However, in the absence of continuing appointment authority, the ability of a primary government to unilaterally abolish an organization also provides the basis for ongoing accountability. Thus, a primary government that creates an organization (creation is tantamount to the initial appointment of the governing body) is accountable for the organization if the primary government can unilaterally abolish it. A primary government is considered to be accountable for an organization as long as continuing appointments are made by the primary government, even if those appointments are made by a subsequent administration.

Imposition of Will

25. A primary government that is accountable for an organization because it appoints a voting majority of that organization's governing body frequently has the ability to affect that organization's operations. Sometimes, however, based on the provisions of law or contract, the primary government has little influence over the organization's operations. Certain conditions indicate the primary government's ability to affect the day-to-day operations of an organization. These conditions are referred to in this Statement as a government's ability to impose its will on an organization. If a primary government appoints a voting majority of an organization's officials *and* has the ability to impose its will on the organization, the primary government is financially accountable for that organization.

26. *A primary government has the ability to impose its will on an organization if it can significantly influence the programs, projects, activities, or level of services performed or provided by the organization.* The existence of *any one* of the following conditions clearly indicates that a primary government has the ability to impose its will on an organization:

a. The ability to remove appointed members of the organization's governing board at will.
b. The ability to modify or approve the budget of the organization.
c. The ability to modify or approve rate or fee changes affecting revenues, such as water usage rate increases.
d. The ability to veto, overrule, or modify the decisions (other than those in b and c) of the organization's governing body.
e. The ability to appoint, hire, reassign, or dismiss those persons responsible for the day-to-day operations (management) of the organization.

Other conditions may also indicate that a primary government has the ability to impose its will on an organization. In determining whether imposition of will exists, a distinction should be made between substantive approvals and ministerial (or compliance) approvals as discussed in paragraphs 17 and 18.

Financial Benefit to or Burden on a Primary Government

27. An organization can provide a financial benefit to, or impose a financial burden on, a primary government in a variety of ways. The benefit or burden may result from legal entitlements or obligations, or it may be less formalized and exist because of decisions made by the primary government or agreements between the primary government and a component unit. If a primary government appoints a voting majority of an organization's officials *and* there is a potential for that organization either to provide specific financial benefits to or to impose specific financial burdens on the primary government, the primary government is financially accountable for that organization. An organization has a financial benefit or burden relationship with the primary government if *any one* of these conditions exists:

a. The primary government is legally entitled to or can otherwise access the organization's resources.
b. The primary government is legally obligated or has otherwise assumed the obligation to finance the deficits of, or provide financial support to, the organization.
c. The primary government is obligated in some manner for the debt of the organization.

Exchange transactions between organizations and the primary government should not be considered manifestations of a financial benefit or burden relationship. In an exchange transaction, such as a purchase or sale of goods or services, each participant (the government or its employees rather than the citizenry) directly receives and sacrifices value. For example, funding by a primary government for higher education is *not* equivalent to purchasing educational services and would be considered a manifestation of a financial burden on the primary government.

28. The effect of the financial benefits or burdens on the primary government can be either direct or indirect. A direct financial benefit or burden occurs when the primary government itself is entitled to the resources or

is obligated for the deficits or debts of the organization. An indirect benefit or burden exists if one or more of the primary government's component units is entitled to the resources or is obligated for the deficits or debts of the organization. For purposes of this Statement, a financial benefit or burden relationship exists if the primary government is either directly or indirectly entitled to the resources or is either directly or indirectly obligated for the deficits or debts of an organization.

29. *Legally Entitled to or Can Otherwise Access the Organization's Resources.* The *ability* to access the resources of an organization—not necessarily whether there was an actual transaction during the period—is the important factor for determining when a primary government is entitled to an organization's resources. However, the ability to access the resources of an organization should be judged in light of the organization as a going concern; that is, a residual interest in the net assets of an organization in the event of dissolution is not equivalent to being entitled to its resources. If a primary government appoints a voting majority of an organization's officials *and* is legally entitled to or can otherwise access the organization's resources, the primary government is financially accountable for that organization.

30. Resources may flow from a component unit to a primary government for several reasons. Some organizations may operate activities, such as off-track betting or lotteries, for the principal purpose of generating net revenues that are accessible to the primary government. These organizations provide financial benefits to the primary government. Other organizations may operate activities (for example, public utilities) for the purpose of providing basic public services and charge rates sufficiently high to also provide a financial benefit to the primary government. These benefits may be characterized as "payments in lieu of taxes" or "contributions," or they may simply be amounts remitted on request of the primary government. These organizations also provide financial benefits to the primary government.

31. *Legally Obligated or Has Otherwise Assumed the Obligation to Finance the Deficits of, or Provide Financial Support to, the Organization.* A primary government may be obligated to finance the deficits of, or provide financial support to, an organization in different ways. It could be legally obligated to do so, or it may choose to do so for a variety of reasons. If a primary government appoints a voting majority of an organization's officials *and* is legally obligated or has otherwise assumed the obligation to finance the deficits of, or provide financial support to, that organization,

the primary government is financially accountable for that organization. The following are examples of financial burdens assumed by a primary government in support of certain organizations:

a. Some organizations provide public services financed by user charges that are not expected to be sufficient to sustain their operations. This situation often results from providing services such as mass transit, higher education, and healthcare. In these cases, public policy may dictate that a state or local government provide financial support to the organization to increase the availability and affordability of the service to a broader segment of the citizenry. Examples of support include annual appropriations to help meet operating expenditures/expenses, periodic capital grants, and direct payment of capital expenditures or debt service.
b. A primary government may assume an obligation to finance the deficits of an organization. These deficits may or may not be expected to recur annually. A financial burden exists if the primary government is obligated to finance an organization's deficits even though there has not been, and may never be, a deficit to subsidize.

32. Some organizations' operations are fully or partially funded by revenues generated through tax increment financing. Legally separate development or redevelopment authorities sometimes receive the incremental taxes that result from a tax increment financing arrangement. When this is done, *a taxing government temporarily waives its right to receive the incremental taxes from its own levy.* The incremental taxes instead are remitted to the separate organization. For purposes of this Statement, this type of tax increment financing should be considered evidence of an obligation to provide financial support to an organization (a financial burden), regardless of whether the primary government collects the taxes and remits them to the organization or the incremental taxes are paid directly to the organization.

33. *Obligated in Some Manner for the Debt of an Organization.* An obligation for the debt of an organization is similar to the notion that a primary government may be obligated for future operating deficits. The obligation can be either expressed or implied. A primary government is obligated in some manner for the debt of an organization if (a) it is legally obligated to assume all or part of the debt in the event of default or (b) it *may* take certain actions to assume secondary liability for all or part of the debt, *and*

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the government takes, or has given indications that it will take, those actions. Conditions that indicate that a primary government is obligated in some manner include:

a. The primary government is *legally obligated* to honor deficiencies to the extent that proceeds from other default remedies are insufficient.
b. The primary government is *required* to temporarily cover deficiencies with its own resources until funds from the primary repayment source or other default remedies are available.
c. The primary government is *required* to provide funding for reserves maintained by the debtor organization, or to establish its own reserve or guarantee fund for the debt.
d. The primary government is *authorized* to provide funding for reserves maintained by the debtor organization or to establish its own reserve or guarantee fund *and* the primary government *establishes* such a fund. (If a fund is not established, the considerations in subparagraphs f and g may nevertheless provide evidence that the primary government is obligated in some manner.)
e. The primary government is *authorized* to provide financing for a fund maintained by the debtor organization for the purpose of purchasing or redeeming the organization's debt, or to establish a similar fund of its own, *and* the primary government *establishes* such a fund. (If a fund is not established, the considerations in subparagraphs f and g may nevertheless provide evidence that the primary government is obligated in some manner.)
f. The debtor government explicitly indicates by contract, such as the bond agreement or offering statement, that in the event of default the primary government *may* cover deficiencies although it has no legal obligation to do so. That is, the bond offering statement may specifically refer to a law that authorizes the primary government to include an appropriation in its budget to provide funds, if necessary, to honor the debt of the organization.
g. Legal decisions within the state or previous actions by the primary government related to actual or potential defaults on another organization's debt make it *probable* that the primary government will assume responsibility for the debt in the event of default.

If a primary government appoints a voting majority of an organization's officials *and* is obligated in some manner for the debt of that organization, the primary government is financially accountable for that organization.

Financial Accountability as a Result of Fiscal Dependency

34. A primary government may be financially accountable for a fiscally dependent government regardless of whether the fiscally dependent government has a separately elected governing board, a board appointed by another government, or a jointly appointed board. Paragraphs 16 – 18 provide the criteria for determining fiscal independence or dependence.

35. *Special-Purpose Governments with Separately Elected Governing Boards.* Many special-purpose governments have separately elected governing boards. Some are fiscally independent, and others are fiscally dependent on another government. For example, many local school boards are separately elected. However, a local general purpose government may approve the school board's budgets and levy a property tax for the school district. These school districts (sometimes called "dependent school districts") should be reported as component units of the primary government on which they are fiscally dependent.

36. *Governmental Organizations with Boards Appointed by Another Government.* Governmental organizations may be fiscally dependent on a local government even when their governing boards are *appointed by a higher level of government.* For example, local school boards in some jurisdictions may be appointed by state officials, but the responsibility for approving the school boards' budgets, authorizing the issuance of debt, and levying their property taxes may be vested in the local general purpose governments (cities or counties) where the school boards are located. As discussed in paragraph 38, these school boards usually would be included in the local government's financial reporting entity because of their *fiscal dependency* on the local government even though the local government does not appoint any members of the school district's governing board.

37. *Governmental Organizations with Jointly Appointed Boards.* In some states there may be governmental organizations, such as port authorities, transportation authorities, river authorities, and other regional governments, that are governed by boards that are appointed by officials of more than one government (for example, a group of local governments, or a state and certain local governments), but none appoints a voting majority. If, however, a governmental organization is fiscally dependent on only one

of the appointing governments (for example, a port authority may not be empowered to issue debt without substantive state approval), it should be included as a component unit of that government.

Potential for Dual Inclusion

38. In some instances, the financial accountability criteria of paragraph 21a indicate that an organization is a component unit of a particular primary government. However, that organization may also be fiscally dependent on another state or local government (as discussed in paragraphs 16–18). In these situations, the organization meets the benchmark for inclusion in more than one reporting entity. However, an organization should be included as a component unit of only one reporting entity. For example, state governments, in particular, mandate functions to be performed by local governments and provide financial aid for a portion of the expenditures. Elementary and secondary education typically is financed through a combination of local taxation and state aid distributed in accordance with legislatively established formulas. In most such instances, the entity status of a school district will be readily apparent as either a primary government or a component unit of a local government because either its governing board is separately elected or a voting majority is appointed by the local government. In some instances, however, school district governing boards are appointed by state officials, and the state may appear to be financially accountable for the district because of the state aid distribution. Judgment needs to be exercised as to whether the district should be considered a component unit of the state or of a local government. Usually, fiscal dependency on a local government, not the financial burden on the state created by legislatively established aid distribution formulas, should govern in determining the appropriate reporting entity of such school districts.

Organizations Included in the Reporting Entity Although the Primary Government Is Not Financially Accountable

39. Paragraph 12(c) requires that certain organizations should be included as component units if the nature and significance of their relationship with the primary governments are such that exclusion from the financial reporting entity would render the financial reporting entity's financial statements incomplete or misleading.

40. In some states, authorities with state-appointed boards may be created to provide temporary fiscal assistance to a local government to alleviate that local government's fiscal distress. The authority should be evaluated as a potential component unit of the local government. If the authority issues debt on behalf of the local government and serves as a conduit for receiving dedicated revenues of the local government that are designated for repayment of the debt, the nature and significance of the relationship between the authority and the local government would warrant including the authority as a component unit of the local government. The temporary nature of the state-created authority emphasizes that the debt and revenues are, in substance, the debt and revenues of the local government.

41. In addition, other organizations should be evaluated as potential component units if they are closely related to the primary government. It is a matter of professional judgment to determine whether the nature and the significance of a potential component unit's relationship with the primary government warrant inclusion. Organizations affiliated with governmental units, agencies, colleges, universities, hospitals, and other entities may warrant inclusion. An example of an affiliated organization that may be evaluated for inclusion is a nonprofit corporation whose purpose is to benefit a governmental university by soliciting contributions and managing those funds. There may also be circumstances warranting inclusion of a single-employer defined-benefit public employee retirement system (PERS) that does not meet the criteria for inclusion in paragraph 21 in the financial reporting entity. The GASB is studying circumstances under which foundations, similarly affiliated organizations, and PERS might be included in the financial reporting entity. Appropriate pronouncements will be issued at a later date.

Reporting Component Units

42. Financial statements of the reporting entity should provide an overview of the entity based on financial accountability, yet allow users to distinguish between the primary government and its component units. Because of the closeness of their relationships with the primary government, some component units should be blended as though they are part of the primary government; however, most component units should be discretely presented.

43. An organization that is a component unit of a financial reporting entity may have component units of its own. The component unit financial data that are incorporated into a reporting entity's financial statements should include the data from all of its component units. In effect, this Statement should be applied in layers "from the bottom up." At each layer, the definition and display provisions should be applied before the layer is included in the financial statements of the next level of the reporting government. For example, a school district may be a component unit of a municipality because the municipality appoints the governing board of the district and the district imposes a financial burden on the municipality. If the school district is financially accountable for another organization (a building authority, for example), the district should apply the definition and display provisions of this Statement to the building authority. The municipality should apply the definition and display provisions of this Statement to the school district's "entity," which includes the building authority. The building authority is not a component unit of the municipality per se; however, its financial data would be included in the primary government's financial reporting entity as a part of the school district.

Discrete Presentation of Component Units

44. As noted in paragraph 42, most component units should be included in the financial reporting entity by discrete presentation. Discrete presentation entails reporting component unit financial data in a column(s) separate from the financial data of the primary government. The reporting entity's combined balance sheet should include one or more columns to display the combined balance sheets of the discretely presented component units. A single column may be used regardless of whether the component units use governmental or proprietary fund accounting or the AICPA College Guide. If a single column is used, equity of the component units may be presented using the same descriptions that are used to display the elements of the primary government's equity; or it may be aggregated into other classifications (for example, "Fund balance—governmental component units," "Retained earnings—proprietary component units," or simply on a single line such as "Equity—component units"). The discrete column(s) should be located to the right of the financial data of the primary government, distinguishing between the financial data of the primary government (including its blended component units) and those of the discretely presented component units by providing descriptive column headings.

45. The reporting entity's combined statement of revenues, expenditures, and changes in fund balance—governmental funds should include one or more columns to display the revenues, expenditures, and changes in fund balances for discretely presented component units that use governmental fund accounting. The column(s) should be located to the right of the financial data of the primary government, distinguishing between the financial data of the primary government (including its blended component units) and those of the discretely presented component units by providing descriptive column headings.

46. Discrete presentation of component units that use proprietary fund accounting should be the same as the display method above (for governmental funds) for both the combined statement of revenues, expenses, and changes in retained earnings/fund balances or fund equity and the combined statement of cash flows.

47. If a component unit uses both governmental and proprietary methods of accounting,[6] its operations may be included in a discrete column on the most appropriate operating statement (based on the component unit's principal activities), or the component unit can be disaggregated and reported in the component units column(s) on the applicable operating statements. When the single operating statement approach is used, the results of operations using the other method of accounting should be reduced to a single amount and presented as a separate line item, such as "Net income from proprietary operations" or "Excess of revenues over expenditures from governmental operations."

48. Reporting entity financial statements for discretely presented component units that use the AICPA College Guide should include a statement of changes in fund balances and a statement of current funds revenues, expenditures, and other changes. These statements should be presented in the format described in paragraph 45 if the reporting entity includes institutions that are component units and institutions that are part of the primary government's legal entity. (See paragraph 19.) The discrete column(s)

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[6] The provisions of this paragraph would be similarly applied to component units that use either (or both) governmental or proprietary fund accounting and also to college and university operations using the AICPA College Guide.

should be located to the right of the financial data of the primary government's institutions. A distinction should be made between the financial data of the primary government's institutions and the data of the discretely presented institutions by providing descriptive column headings.

49. If the reporting entity chooses to provide a total column for the primary government (including its blended component units), the column should be labeled "memorandum only." Likewise, if the reporting entity's combined statements include a total column for the reporting entity as a whole, it also should be labeled "memorandum only." The component units column(s) should not be labeled "memorandum only." In addition, if the entity provides a total column for the entity as a whole, a total column for the primary government should be presented, consistent with the notion in paragraph 13 that the primary government is the focal point for the users of financial statements.

50. Combining financial statements for discretely presented component units should be included in the reporting entity's comprehensive annual financial report (CAFR) using the same methodology as combining (and individual fund) statements of the fund types of the primary government. (See Cod. Sec. 2200.105 and .106.) The data presented for each component unit in the combining statements generally should be its aggregated totals. Presentation of the underlying fund types of the individual component units is not required unless such information is not available in separately issued financial statements of the component unit. If the entity chooses to present more than one column for the discretely presented component units (for example, separate columns for component units that use governmental fund accounting and those that use proprietary fund accounting), separate combining statements should be presented for each column in the combined statements.

Individual Component Unit Disclosures

51. Certain information should be disclosed about each major component unit included in the component units column(s) in the general purpose financial statements (GPFS). In determining which component units are "major," consideration should be given to each component unit's significance relative to the other component units and the nature and significance of its relationship to the primary government. The required information may be presented either (a) by including the combining statements required in paragraph 50 in the reporting entity's GPFS or (b) by present-

ing condensed financial statements in the notes to the reporting entity's financial statements. If the condensed financial statement disclosure approach is taken, at a minimum, the following details should be separately presented.

Condensed balance sheet:

a. Current assets. (Amounts due from the primary government and other component units should be separately identified.)
b. Property, plant, and equipment (including general fixed assets).
c. Amounts to be provided (and available) for the retirement of general long-term debt.
d. Current liabilities. (Amounts due to the primary government and other component units should be separately identified.)
e. Bonds and other long-term liabilities outstanding. (Amounts due to the primary government and other component units should be separately identified.)

Condensed statements of revenues, expenses, and changes in equity for component units that use proprietary fund accounting:

a. Operating revenues (total revenues from sales of goods or services). (Sales to the primary government and other component units should be separately identified.)
b. Operating expenses. (Depreciation, depletion, and amortization expense should be separately identified.)
c. Operating income or loss (operating revenues less operating expenses).
d. Operating grants, entitlements, and shared revenues.
e. Transfers to/from the primary government and other component units.
f. Tax revenues.
g. Net income or loss (total revenues less total expenses).
h. Current capital contributions.

Condensed statements of revenues, expenditures, and changes in fund balances for component units that use governmental fund accounting:

a. Revenues.
b. Current expenditures.
c. Capital outlay expenditures.
d. Debt service expenditures.
e. Transfers to/from the primary government and other component units.
f. Excess (deficiency) of revenues and expenditures.

information for all nonmajor discretely presented component units should be presented in the aggregate. If the entity presents a separate column in the GPFS for each component unit, these disclosures (and the combining statements in paragraph 50) are not required.

Blending Component Units

52. Even though it is desirable for users to be able to distinguish between the primary government and its component units, there are nevertheless some component units that, despite being legally separate from the primary government, are so intertwined with the primary government that they are, in substance, the same as the primary government. These component units should be reported as part of the primary government. That is, the component unit's balances and transactions should be reported in a manner similar to the balances and transactions of the primary government itself. This method of inclusion is known as blending.

53. A component unit should be included in the reporting entity financial statements using the blending method in either of these circumstances:

a. The component unit's governing body is substantively the same as the governing body of the primary government.[7]
b. The component unit provides services entirely, or almost entirely, to the primary government or otherwise exclusively, or almost exclusively, benefits the primary government even though it does not provide services directly to it. The essence of this type of arrangement is much the same as an internal service fund—the goods or services are provided to the government itself rather than to the citizenry. Usually the services provided by a blended component unit are financing services provided solely to the primary government. For example, a building authority may be created to finance the construction of office

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[7] "Substantively the same" means sufficient representation of the primary government's entire governing body on the component unit's governing body to allow complete control of the component unit's activities. To illustrate, the board of a city redevelopment authority may be composed entirely of the city council and the mayor, serving ex officio. The primary government is, essentially, serving as the governing body of the component unit. On the other hand, the board of a public housing authority composed of the city mayor and two council members (from a total of ten) ordinarily would not be substantively the same as the city's governing body. This criterion will rarely, if ever, apply to a state government because of the impracticality of providing sufficient representation of the state's entire governing body

buildings for the primary government. However, a component unit that provides services to more than just the primary government should also be blended if the services provided to others are insignificant to the overall activities of the component unit. Other component units that should be blended are those that exclusively, or almost exclusively, benefit the primary government by providing services indirectly. For example, a component unit established by a primary government to administer its employee benefit programs exclusively benefits the primary government even though it provides services to the employees rather than directly to the primary government itself.

54. Some component units account for their activities in a single fund; others use all or several fund types and account groups. If a component unit is blended, the fund types and account groups of the component unit should be blended with those of the primary government by including them in the appropriate combining statements of the primary government. However, because the primary government's general fund is usually the main operating fund of the reporting entity and often is a focal point for report users, its general fund should be the only general fund for the reporting entity. The general fund of a blended component unit should be reported as a special revenue fund.

Investments in For-Profit Corporations

55. If a government owns a majority of the voting stock of a for-profit corporation, the government's intent for owning the stock should determine whether the corporation is presented as a component unit or an investment of the primary government. For example, a government that purchases 100 percent of the stock of a concrete plant to provide a controlled source of concrete for its capital projects should report the concrete company as a component unit. The intent of the government in obtaining the company is to directly enhance its ability to provide governmental services. On the other hand, a government that purchases stock of a corporation as an investment rather than to directly aid in the provision of governmental services should report the stock as an investment.

Budgetary Presentations

56. Codification Section 1900, "Financial Reporting," requires presentation in the GPFS of a combined statement of revenues, expenditures, and changes in fund balances—budget and actual—general and special reve-

nue fund types (and similar governmental fund types for which annual budgets have been legally adopted). The minimum budget-basis presentation within the GPFS of a reporting entity is the aggregation by fund type of the appropriated budgets for those funds, as amended, compared with related actual amounts. For purposes of this presentation, the appropriated budgets are those adopted by the legislative or governing board of the primary government (and its component units that have been blended and are, as a result, reported as part of the primary government). Budgetary data for the discretely presented component units are not required to be presented in the reporting entity's combined statement of revenues, expenditures, and changes in fund balances—budget and actual.

Intra-Entity Transactions and Balances

57. Some transactions and balances between a primary government and its component units (and among the component units) may need to be reclassified for presentation in the reporting entity's financial statements. Transfers between the primary government and its blended component units (and among the blended component units) should be reported as required by Codification Section 1800, "Classification and Terminology," paragraphs .102–.107, for interfund transfers. Similarly, receivables and payables between the primary government and its blended component units should be reported as amounts due to and due from other funds. Balances and transfers between the primary government and component units that are discretely presented (and among those component units) should be reported in accordance with Cod. Sec. 1800.102–.107, except that the amounts of the balances and transfers (due to/from and transfers to/from component units) should be reported separately from interfund balances and transfers (due to/from and transfers to/from other funds).[8]

58. Capital lease arrangements between the primary government and blended component units (or between blended component units) should not be reported as capital leases in the financial reporting entity's financial statements. Instead, the lease arrangement should be reported in accordance with Codification Section L20, "Leases," paragraph .126. The debt and

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[8] Although Codification Section 1300, "Fund Accounting," paragraph .110, allows current amounts due to and due from the *same* funds to be offset and the net amounts shown in the respective fund balance sheets, this right of offset may not be enforceable at law for the legally separate *component units*. Therefore, the option to offset may be exercised only if there is a legal right to offset.

assets of the blended component unit should be reported as a form of the primary government's debt and assets. For example, the leased general fixed assets would be reported in the General Fixed Assets Account Group (GFAAG) and related debt would be reported in the General Long-Term Debt Account Group (GLTDAG). The debt service activity of the blended component unit would be reported as a debt service activity of the primary government. If the blended component unit has a general fund, it would be included as a special revenue fund of the primary government. Capital lease arrangements between the primary government and discretely presented component units (or between those component units) should be reported as discussed in Cod. Sec. L20.127. Related receivables and payables should be reported separately from other amounts due to or due from component units and separately from capital lease receivables and payables from organizations outside the reporting entity. To avoid double counting of assets and liabilities resulting from capital lease arrangements, eliminations may be made in accordance with Cod. Sec. 2200.108.

Reporting Periods

59. The primary government and its component units may have identical or different fiscal year-ends. A common fiscal year-end for the primary government and all component units is encouraged. The advantages and disadvantages of a common fiscal year-end should be considered when determining the practicality of making such a requirement. If it is determined that a common fiscal year-end is impractical, the reporting entity (which reports using the primary government's fiscal year) should incorporate financial statements for the component unit's fiscal year ending during the reporting entity's fiscal year. If the component unit's fiscal year ends within the first quarter of the reporting entity's subsequent fiscal year, it is acceptable to incorporate that fiscal year of the component unit, rather than the fiscal year ending during the reporting entity's fiscal period. Of course, this should be done only if timely and accurate presentation of the financial statements of the reporting entity is not adversely affected.

60. If transactions between component units that have different fiscal years result in inconsistencies in amounts reported as due to or due from, transfer to or transfer from, and so forth, the nature and amount of those transactions should be disclosed in the notes to the financial statements. The fiscal year of the component units included in the reporting entity should be consistent from year to year, and changes in fiscal years should be disclosed.

Note Disclosures

61. The notes to the reporting entity's financial statements should include a brief description of the component units of the financial reporting entity and their relationships to the primary government. This disclosure should include a discussion of the criteria for including the component units in the financial reporting entity and how the component units are reported. The notes should also include information about how the separate financial statements for the individual component units may be obtained.

Focus of the Reporting Entity's Note Disclosures and Required Supplementary Information

62. One of the key aspects of the reporting entity concept is that users should be able to distinguish between the primary government and its component units. Thus, because the notes and required supplementary information (RSI) are integral parts of the financial statements, they should distinguish between information pertaining to the primary government (including its blended component units) and that of its discretely presented component units.

63. Notes essential to fair presentation in the reporting entity general purpose financial statements encompass:

a. The fund types and account groups of the primary government including its blended component units.
b. Individual discretely presented component units considering both:
    (1) The unit's significance relative to the total discretely presented component units.
    (2) The nature and significance of the unit's relationship to the primary government.

Determining which discretely presented component unit disclosures are essential to fair presentation is a matter of professional judgment and should be done on a component unit–by–component unit basis. A specific type of disclosure might be essential for one component unit but not for another depending on the component unit's significance relative to the total component units included in the component units column(s) and the individual component unit's relationship with the primary government.

Primary Government Separate Financial Statements

64. A primary government may find it useful or necessary (for example, to satisfy specific legal requirements) to issue financial statements that do not include the financial data of its component units. Paragraph 9 states that the provisions of this Statement apply to financial reporting by primary governments; thus, financial statements that present only the data of the primary government should acknowledge that the financial statements do not include the data of the component units necessary for reporting in conformity with generally accepted accounting principles.

Component Unit Financial Statements

65. Although the nucleus of a financial reporting entity usually is a primary government, an organization other than a primary government, such as a component unit, may serve as a nucleus for a reporting entity when it issues separate financial statements. The requirements of this Statement apply to the separately issued financial statements of governmental component units. As noted in paragraph 43, this Statement should be applied in layers "from the bottom up." That is, each component unit "layer" should apply the definition and display provisions to its own component unit financial reports. Because this Statement is written from the perspective of the primary government, a governmental component unit should apply the provisions of this Statement as if it were a primary government. Separately issued financial statements of a component unit should acknowledge that it is a component unit of another government—for example, "Sample County School District, a component unit of Sample County." In addition, the notes to the financial statements should identify the primary government in whose financial reporting entity it is included and describe its relationship with the primary government.

Other Stand-Alone Government Financial Statements

66. Other stand-alone governments are legally separate governmental organizations that (a) do not have a separately elected governing body and (b) do not meet the definition of a component unit as discussed in paragraph 21. Other stand-alone governments include some special-purpose governments, joint ventures, jointly governed organizations, and pools. Although the nucleus of a financial reporting entity usually is a primary government, an organization other than a primary government (such as an other stand-alone government) serves as a nucleus for its reporting entity when it issues finan-

cial statements. The requirements of this Statement apply to the separately issued financial statements of all state and local governments. Because this Statement is written from the perspective of a primary government, a stand-alone government should apply the provisions of this Statement as if it were a primary government. The financial reporting entity consists of the stand-alone government and all component units for which it is financially accountable, and other organizations for which the nature and significance of their relationship with the stand-alone government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete. (See paragraphs 21–41.) In accordance with paragraph 68, any stand-alone government with a voting majority of its governing board appointed by a primary government should disclose that accountability relationship in its financial statements.

Reporting Relationships with Organizations Other Than Component Units

67. Primary government officials may appoint some, or all, governing board members of organizations that are not included as component units in the primary government's reporting entity. These organizations are classified as (a) **related organizations,** (b) joint ventures and jointly governed organizations, and (c) component units of another government with characteristics of a joint venture or jointly governed organization.

Related Organizations

68. Organizations for which a primary government is accountable because that government appoints a voting majority of the board, but is not financially accountable, are related organizations. The primary government should disclose in the notes to the financial statements the nature of its accountability for related organizations. Groups of related organizations with similar relationships with the primary government may be summarized for purposes of the disclosure. In addition, the primary government should disclose any other information required by Codification Section 2300, "Notes to Financial Statements," paragraph .105f. The financial statements of a related governmental organization should disclose the primary government that is accountable for it and describe its relationship with that primary government.

Joint Ventures

69. A joint venture is a legal entity or other organization that results from a contractual arrangement and that is owned, operated, or governed by two or more participants as a separate and specific activity subject to joint control, in which the participants retain (a) an **ongoing financial interest** or (b) an **ongoing financial responsibility.** Generally, the purpose of a joint venture is to pool resources and share the costs, risks, and rewards of providing goods or services to the venture participants directly, or for the benefit of the general public or specific service recipients. *Joint control* means that no single participant has the ability to unilaterally control the financial or operating policies of the joint venture. If the organization is jointly controlled but the participants do not have an ongoing financial interest or ongoing financial responsibility, as defined in paragraphs 70 and 71, it is a *jointly governed organization*, rather than a joint venture. Reporting requirements for participants in jointly governed organizations are provided in paragraph 77.

Ongoing Financial Interest

70. An *ongoing financial interest* in a joint venture includes an **equity interest,** as defined in paragraph 72, and any other arrangement that causes a participating government to have access to the joint venture's resources. Access to the joint venture's resources occurs *directly*, such as when the joint venture pays its surpluses to the participants, or *indirectly*, such as when the joint venture undertakes projects of interest to the participants. For example, indirect access occurs when the participating governments are able to influence the management of the joint venture so that the joint venture uses its surplus resources to undertake special projects for the participants' citizenry.

Ongoing Financial Responsibility

71. A participating government has an *ongoing financial responsibility* for a joint venture if it is obligated in some manner for the debts (as described in paragraph 33) of the joint venture, or if the joint venture's continued existence depends on continued funding by the government. Often, joint ventures are created by two or more governments to provide goods or services directly to the governments or to provide goods or services to their constituencies on behalf of the governments. Consequently, a participating government is responsible for financing the operations of

the joint venture, either by purchasing the joint venture's goods or services for its own use or by subsidizing the provision of the joint venture's services to the citizenry. For example, if a city/county public safety operation and facility is dependent on ongoing funding by the city and the county, the city and the county both have an ongoing financial responsibility. Similarly, the continued existence of a regional sewer utility that provides sewage treatment services to three cities (in relatively equal proportions) is dependent on the ongoing revenues from each of the three cities; therefore, each of the cities has an ongoing financial responsibility. On the other hand, an electric utility cooperative that generates power for sixteen cities (in relatively equal proportions) does *not* depend on the revenues from any single participant to continue in existence. Thus, one can conclude that none of the sixteen participants has a financial *responsibility* for the utility, unless one or more of the participants is obligated in some manner for the debt of the utility.[9]

Equity Interest

72. For financial reporting purposes, there are two types of joint ventures: (a) joint ventures whose participants have equity interests and (b) joint ventures whose participants do not have equity interests. An equity interest in a joint venture is manifest in the ownership of shares of joint venture stock or by otherwise having an explicit, measurable right to the net resources of a joint venture that is usually based on an investment of financial or capital resources by a participating government. An equity interest may or may not change over time as a result of an interest in the net income or loss of the joint venture. An equity interest is explicit and measurable if the joint venture agreement stipulates that the participants have a present or future claim to the net resources of the joint venture and sets

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[9] As the number of participants in a joint venture increases, the relative financial responsibility of each participant decreases accordingly. There is no exact point at which one can determine that a participant no longer has a financial responsibility for a joint venture—it becomes a matter of professional judgment. At issue is whether a participant should make all the disclosures in paragraph 75 (if there is financial responsibility) or only the disclosures in part b of that paragraph (if there is no financial responsibility). Thus, for situations at the margin, the participating government should evaluate whether the additional disclosures in paragraph 75a would provide useful information to financial statement users.

forth the method to determine the participants' shares of the joint venture's net resources.[10] As discussed below, if the government has an equity interest in the joint venture, that equity interest should be reported as an asset of the fund that has the equity interest.

Reporting Participation in Joint Ventures in Which There Is an Equity Interest

73. *Proprietary Funds.* The "Investment in joint venture" account reported in a proprietary fund should report the participating government's equity interest calculated in accordance with the joint venture agreement. Initially, the investment in the joint venture should be reported at cost. If the joint venture agreement provides for the participating government to share in the operating results of the joint venture, the equity interest should be adjusted for the participant's share of the joint venture's net income or loss, regardless of whether the amount is actually remitted. In calculating the participant's share of the net income or loss of the joint venture, any profit on the operating transactions between the proprietary fund and the joint venture should be eliminated. Nonoperating transactions between the joint venture and the proprietary fund should increase or decrease the equity interest. The equity interest should be reported in the proprietary fund's balance sheet as a single amount, and the fund's share of the joint venture's net income or loss should be reported in its operating statement as a single amount.

74. *Governmental Funds.* Because the equity interest in a joint venture generally represents equity primarily in capital assets and otherwise does not meet the definition of a financial resource, it is inappropriate to report the entire "Net investment in joint venture" as an asset in a governmental fund. All or a portion of the equity interest should be reported in the GFAAG. The participating government's total equity interest should be calculated in accordance with the joint venture agreement. The amount that should be reported in the GFAAG is the total equity interest adjusted for any portion of the equity interest that is included in the balance sheet of a governmental fund. For example, if the general fund reports an amount payable to, or receivable from, the joint venture, the "net invest-

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[10] The definition of equity interest is not intended to include a governmental unit's residual interest in assets that may (on dissolution) revert to the governmental unit for lack of another equitable claimant. This type of interest is, in substance, the same as escheatage, that is, the reversion of property to a state resulting from the absence of any known, rightful inheritors to the property.

ment" account in the GFAAG should be adjusted by that amount. Thus, the combination of amounts reported in the governmental funds and in the GFAAG should equal the total equity interest in the net assets of the joint venture. Governmental fund operating statements should report changes in joint venture equity interests only to the extent that the amounts received or receivable from the joint venture or the amounts paid or payable to the joint venture satisfy the revenue or expenditure recognition criteria for governmental funds.

Disclosure Requirements for Joint Venture Participants

75. Regardless of whether there is an equity interest, joint venture participants should make these disclosures in the notes to the financial statements:

a. A general description of each joint venture, including:
   (1) Description of the participating government's ongoing financial interest (including its equity interest, if applicable) or ongoing financial responsibility. This disclosure should also include information to allow the reader to evaluate whether the joint venture is accumulating significant financial resources or is experiencing fiscal stress that may cause an additional financial benefit to or burden on the participating government in the future.
   (2) Information about the availability of separate financial statements of the joint venture.

b. The participating government should also disclose any other information required by Cod. Sec. 2300.105f.

Joint Building or Finance Authorities

76. Because of the accounting requirements for capital leases, some joint ventures are, in substance, the same as undivided-interest arrangements (see paragraph 80) except that a formal organization is created. Depending on the specific language of the joint venture agreement, there may or may not be an equity interest in the joint authority (a debt service reserve, for example). A common example is a joint building authority whose sole purpose is to construct or acquire capital assets for the participating governments and subsequently lease the facilities to the governments. In accounting for these capital lease arrangements, the participating governments already should have reported their respective shares of the assets, liabilities, and operations of the joint venture. As a result, it is

unnecessary to calculate and report a participant's equity interest (if any) in the joint building authority. Similarly, the disclosures in paragraph 75 are not required because they would duplicate other disclosures required in Cod. Sec. L20.

Jointly Governed Organizations

77. The laws in many states provide for the creation of regional governments or other multigovernmental arrangements that are governed by representatives from each of the governments that create the organization. These organizations may appear similar to joint ventures—they provide goods or services to the citizenry of two or more governments—but many do not meet the definition of a joint venture because there is no ongoing financial interest or responsibility by the participating governments. If a participant does not retain an ongoing financial interest or responsibility in the organization, only the disclosures in paragraph 75b are required.

Component Units and Related Organizations with Joint Venture Characteristics

78. An organization may have several participants, but if one participating government appoints a voting majority of the organization's governing body (and joint control is precluded because that participant has the power to make decisions unilaterally), the organization is either a component unit or a related organization of that participating government and should be reported in that participating government's financial statements in accordance with the provisions of paragraphs 42–54 and 68. However, the other (minority) participants should report their participation in the organization in accordance with the requirements of paragraphs 73–77. The organization itself, when included as a component unit in the majority participant's financial reporting entity, should report any equity interests (see paragraph 72) of the minority participants as fund balance or retained earnings "reserved for minority interests." In addition, as discussed in paragraph 37, there may be instances where a jointly controlled organization (such as a regional government) is considered a component unit of one of the participating governments because it is fiscally dependent on that participating government. This type of organization should be reported, by all participants, in the manner described earlier in this paragraph.

Pools

79. A "pool" is another multijurisdictional arrangement that has the characteristics of a joint venture but has additional features that distinguish it, for financial reporting purposes, from the traditional joint venture defined in paragraph 69. For example, an investment pool generally has "open" membership; that is, governments are free to join, resign, and increase or decrease their participation in the pool without the knowledge or consent of the other participants. Furthermore, a participant's equity interest in the pool (for example, its share of investments in an investment pool) should already be recognized in its financial statements; thus, calculating and reporting an equity interest as defined in paragraph 72 would be redundant. Additionally, because of the broad-based, constantly changing membership shares in a pool, the disclosures in paragraph 75 would likely not provide useful information and are, therefore, not required. Entities participating in a public entity risk (insurance) pool should follow the accounting and reporting guidance provided in Codification Section C50, "Claims and Judgments."

Undivided Interests

80. An "undivided interest" (also known as a joint operation) is an arrangement that resembles a joint venture but no entity or organization is created by the participants. An undivided interest is an ownership arrangement in which two or more parties own property in which title is held individually to the extent of each party's interest. Implied in that definition is that each participant is also liable for specific, identifiable obligations (if any) of the operation. Because an undivided interest is not a legal entity, borrowing to finance its operations often is done individually by each participant. An additional consequence of the absence of a formal organizational structure is that there is no entity with assets, liabilities, expenditures/expenses, and revenues—and thus, *equity*—to allocate to participants. A government participating in this type of arrangement should report its assets, liabilities, expenditures/expenses, and revenues that are associated with the joint operation. The disclosures in paragraph 75 are not required for undivided interests. Some joint venture agreements may result in hybrid arrangements; they create separate organizations but provide for undivided interests in specific assets and liabilities and equity interests in the other net resources of the organization. In

these situations the participants should report their undivided interests in accordance with the provisions of this paragraph and their equity interests in accordance with paragraphs 73 and 74.

Cost-Sharing Arrangements

81. Cost-sharing projects (such as highway projects financed by federal, state, and local governments) should not be considered joint ventures because the participating governments do not retain an ongoing financial interest or responsibility in the projects. Joint purchasing agreements, in which a group of governments agree to purchase a commodity or service (for example, water or electricity) over a specified period of time and in specified amounts, also should not be considered joint ventures. In addition, multiple-employer PERS are not considered joint ventures for purposes of this Statement. Reporting and disclosure requirements for multiple-employer PERS are included in Codification Sections Pe5, "Pension Funds—Accounting," and Pe6, "Pension Funds—Disclosure."

EFFECTIVE DATE AND TRANSITION

82. The provisions of this Statement are effective for financial statements for periods beginning after December 15, 1992. Earlier application is encouraged. Adjustments resulting from a change to comply with this Statement should be treated as an adjustment of prior periods. The financial statements of all prior periods presented should be restated, if practical, to show the financial information of the new reporting entity for all periods. If restatement of the financial statements for prior periods is not practical, the cumulative effect of applying this Statement should be reported as a restatement of beginning fund balance or retained earnings, as appropriate, for the earliest period restated. In the period this Statement is first applied, the financial statements should disclose the nature of the restatement and its effect.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the affirmative votes of three members of the Governmental Accounting Standards Board. Messrs. Freeman and Mandolini dissented.

Mr. Freeman and Mr. Mandolini dissent because they believe that the reporting entity definition is too broad and the expanded discrete presentation of aggregated component units is inconsistent with the underlying concepts and structure of the current governmental fund and fund-type reporting model. Specifically, Mr. Freeman and Mr. Mandolini believe that the reporting entity definition will result in the inclusion of certain component units that are not in substance part of the primary government. Indeed, organizations may be required to be included as component units in the reporting entity when the primary government cannot control, or even significantly influence, the organizations. For example, a city is considered to be accountable under this pronouncement for an authority's actions if the city's mayor (executive branch) appoints the authority's board without any requirement for city council (legislative branch) approval or confirmation. This accountability would exist even if the mayor and the council members are of different political parties, if the mayor subsequently does not seek reelection, or if the mayor is defeated in a reelection attempt.

Mr. Freeman and Mr. Mandolini are particularly concerned with the broad nature of the financial benefit and burden criteria. They do not believe a component unit should be included in the reporting entity based on a potential burden that may result from a remote contingency. In the example above, if the city were contingently liable (that is, obligated in some manner) for the authority's debt, the authority would be considered a component unit when the financial burden criteria of this pronouncement are applied. Under the most stringent standards that currently apply to state and local governmental financial statements, these situations would result in either note disclosure for debt issues or no disclosure for other contingencies.

Mr. Mandolini also believes that the disclosure of the criteria for including component units will not provide an adequate distinction among component units that are included in the reporting entity based on the criterion of imposition of will, financial benefit and burden, fiscal dependency, or "otherwise misleading or incomplete to exclude." Without further identification in the financial statements of these relationships, he is concerned that users will not understand the degree of the primary government's responsibility or accountability for the component units.

The display standards are of even greater concern to Mr. Freeman and Mr. Mandolini. They believe that significant changes in the display of the component units in the financial statements should have been deferred to the financial reporting model project. This would have given financial statement users, preparers, and attestors the opportunity to assess various options within the context of the entire reporting model rather than in the narrower scope of the reporting entity project. Moreover, they believe that the reporting entity decisions should not prejudge either future general purpose reporting standards or popular reporting standards.

In addition, Mr. Freeman and Mr. Mandolini are concerned with the implications of reporting component units—with multiple funds, fund types, and account groups—in a single discrete column in general purpose financial statements. Although financial statement users may want to distinguish between the primary government and component unit financial information, Mr. Freeman and Mr. Mandolini believe this goal could have been accomplished without the aggregation of component unit information into a discrete presentation, which adds to the complexity of the financial statements. Moreover, they believe data presented in this column will neither demonstrate accountability nor provide useful financial information for decision-making purposes.

Further, Mr. Freeman and Mr. Mandolini believe that the potential aggregation of component units that use up to three different measurement focus and basis of accounting models into a single column in general purpose reports is incompatible with basic governmental fund accounting concepts and principles. They believe their position is supported by the GASB's Research Reports, *The Needs of Users of Governmental Financial Reports* (by Jones and Others) and *Financial Reporting by State and Local Governments: A Survey of Preferences among Alternative Formats* (by Wilson), which indicate that financial statement users prefer fund-type statements over aggregated or consolidated statements (which a single column with eliminations represents).

Mr. Freeman and Mr. Mandolini are concerned with two additional financial reporting issues. They believe the elimination of component unit budgetary reporting in the general purpose financial statements diminishes the value and usefulness of the financial information provided and does not achieve the desired goal of accountability. They also believe that additional guidance should have been provided to financial statement preparers on the level of disclosure necessary for the fair presentation of discretely presented component units and on the definition of "major" component units disclosed in condensed financial statement information.

Mr. Mandolini also believes that a single-column discrete presentation should retain the "memorandum only" heading as illustrated in the Exposure Draft. He is concerned that not using the "memorandum only" heading suggests acceptance and usefulness of consolidated data in governmental financial reports. Moreover, he believes that the discrete column is not equivalent to a fund type and, therefore, the "memorandum only" label should continue to be required, as is the case for the component unit totals in their separately issued reports.

Members of the Governmental Accounting Standards Board:

James F. Antonio, *Chairman*
Martin Ives, *Vice-Chairman*
Robert J. Freeman
W. Gary Harmer
Anthony M. Mandolini

Appendix E

Governmental Accounting Standards Board Exposure Draft, *The Financial Reporting Entity—Affiliated Organizations*

Proposed Statement of the Governmental Accounting Standards Board

The Financial Reporting Entity—Affiliated Organizations

December 9, 1994

INTRODUCTION

1. GASB Statement No. 14, *The Financial Reporting Entity*, establishes standards for defining and reporting on the financial reporting entity. Paragraph 12 of that Statement states that the financial reporting entity consists of (a) the primary government, (b) organizations for which the primary government is financially accountable, and (c) other organizations for which the nature and significance of their relationship with the primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete. With regard to item c, paragraph 41 of that Statement cites a nonprofit fund-raising corporation as an example of an organization affiliated with a college that should be evaluated as a potential component unit. However, the Statement does not provide specific guidance for evaluating these organizations.

STANDARDS OF GOVERNMENTAL ACCOUNTING AND FINANCIAL REPORTING

Scope and Applicability of This Statement

2. This Statement establishes a definition for *affiliated organizations* and financial reporting guidance for those organizations. The requirements of this Statement apply at all levels to all state and local governments. This Statement applies to financial reporting by primary governments and other stand-alone governments, and to the separately issued financial statements of governmental component units as defined in Statement 14.[1] In addition, this Statement should be applied to nongovernmental component units when they are included in a governmental financial reporting entity. This Statement amends paragraphs 21, 41, and 53b of Statement 14.

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[1] Paragraph 13 of Statement 14 defines the term *primary government*. Consistent with Statement 14, this Statement is written from the perspective of a primary government. In accordance with Statement 14, paragraph 12, component units of a primary government (such as colleges, universities, and hospitals) should apply the provisions of this Statement as if they themselves were primary governments.

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Definition of an Affiliated Organization

3. For purposes of this Statement, an organization that meets all of these criteria is considered to be an affiliated organization:

a. The organization has separate legal standing, where neither direct association through appointment of a voting majority of the organization's governing body nor fiscal dependency exists.[2]
b. The affiliation with a specific primary government is set forth in the organization's articles of incorporation—for example, by reference to the name of the primary government in describing the purposes for which the organization was established.
c. The affiliation with a specific primary government is set forth in the organization's application to the Internal Revenue Service for exemption from payment of federal income tax pursuant to Internal Revenue Code (IRC) 501(c)(3)—for example, by reference to the name of the primary government in response to any of the questions contained in the exemption application—and the organization has been granted that exemption.

Reporting Affiliated Organizations

Affiliated Organizations Included as Component Units in the Financial Reporting Entity

Primary Goverment

4. An affiliated organization, as defined in paragraph 3, should be reported as a component unit of the primary government if the primary government has the ability to *impose its will* on that organization (as discussed in Statement 14, paragraphs 25 and 26) or there is a potential for the organization to provide specific *financial benefits* to, or impose specific *financial burdens* on, the primary government (Statement 14, paragraphs 27–33).[3]

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[2] If direct association through appointment of a voting majority of the organization's governing body or fiscal dependency exists, the provisions of Statement 14 should be applied.

[3] In addition, an affiliated organization should be reported as a component unit of the primary government if the nature and significance of its relationship with the primary government are such that exclusion would cause the primary government reporting entity financial statements to be misleading or incomplete, in accordance with paragraph 41 of Statement 14.

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5. An affiliated organization component unit should be included in the financial reporting entity by discrete presentation.[4] Specific transactions of affiliated organization component units should be reported as follows:

a. Grants, allocations, and other types of assistance made to or on behalf of the primary government should be identified in the separate financial statements of the affiliated organization component units and reported in the primary government financial reporting entity's financial statements in accordance with the intra-entity transaction and balance requirements of Statement 14, paragraph 57. If these benefits are not paid directly to the primary government, they should be reported as follows:
   (1) Salaries and fringe benefits on behalf of primary government employees should be classified as transfers-out and transfers-in, in accordance with GASB Statement No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance*, paragraph 14.
   (2) Other payments for which the primary government is legally liable, such as utility bills, should also be reported as transfers-out and transfers-in.

b. The note disclosure requirements of Statement 14, paragraphs 61–63, should be applied to affiliated organization component units.

Affiliated Organizations

6. An affiliated organization component unit that issues separate financial statements should apply the component unit financial statement provisions of Statement 14, paragraph 65.

Required Disclosures for Affiliated Organizations Not Included in the Financial Reporting Entity

7. The primary government financial reporting entity and affiliated organizations, as defined in paragraph 3, that issue financial statements should apply the related organization disclosure requirements provided in Statement 14, paragraph 68, for affiliated organizations that do not meet the component unit criteria provided in paragraph 4.

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[4] Discrete presentation, for those colleges and universities that follow the AICPA College Guide model, as defined in GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*, means "presented in a separate discrete column(s)."

EFFECTIVE DATE AND TRANSITION

8. The provisions of this Statement are effective for financial statements for periods beginning after December 15, 1995. Earlier application is encouraged. Adjustments resulting from a change to comply with this Statement should be treated as adjustments of prior periods. The financial statements of all prior periods presented should be restated, if practical, to show the financial information of the new reporting entity for all periods. If restatement of the financial statements for prior periods is not practical, the cumulative effect of applying this Statement should be reported as a restatement of beginning fund balance for the earliest period restated. In the period this Statement is first applied, the financial statements should disclose the nature of the restatement and its effect.

The provisions of this Statement need not be applied to immaterial items.

Appendix A

BACKGROUND INFORMATION

9. Statement 14 recognizes two categories of component units that, together with a primary government, constitute a financial reporting entity: (a) organizations for which the primary government is financially accountable and (b) other organizations for which the nature and significance of their relationship with the primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete. Statement 14 recognizes, however, that there are other types of relationships among organizations that may warrant inclusion of a particular organization in a financial reporting entity.

10. These relationships generally result from the existence of legally separate organizations that are created for the express purpose of assisting a primary government to accomplish its programs but are not subject to the government's organizational or procedural oversight as described in paragraphs 21–37 of that Statement. Recognizing that establishing specific standards for including those organizations in the reporting entity would require further research, the Board issued Statement 14 to provide timely guidance on the more pervasive entity issues. This Statement covers many of the other organizations not specifically addressed by Statement 14.

11. Many affiliated organizations are established for the primary purpose of raising funds in support of the programs of the specific primary government with which they are affiliated—for example, general instruction and research programs, construction activities, and student loans or scholarships. These affiliated organizations often include terms such as *foundation, development foundation,* or *booster club* in their names. Colleges and universities often have fund-raising affiliates; other entities such as hospitals, museums, and elementary and secondary education institutions may also have similar support organizations.

12. Sometimes, affiliated organizations are established to assist in performing other functions of a specific primary government; these organizations may also undertake fund-raising activities. For example, athletic associations may be established for the purpose of supporting the athletics program of specific colleges, universities, or high schools by selling tickets to sporting events and organizing fund-raising appeals and other events. As another example, research foundations may be established for the specific purpose of undertaking research in the name

of or on behalf of primary governments, pursuant to grants or contracts from federal agencies, other governmental agencies, and private entities. Often, these affiliated organizations utilize plant and other facilities owned by the primary governments as well as personnel employed by these governments.

History of the Project

13. In July 1990, the Board established the affiliated organizations project. In August of that year, with the assistance of the National Association of College and University Business Officers (NACUBO), the GASB surveyed the NACUBO members on issues associated with potential affiliated organizations. After analyzing the results of the survey, the Board determined that the affiliated organizations project was broader than colleges and universities, and organizations potentially affiliated with other governmental entities were identified. A twelve-member task force provided input on the alternatives considered by the Board.

Appendix B

BASIS FOR CONCLUSIONS

14. This appendix discusses factors considered significant by Board members in reaching the conclusions in this Statement. It includes discussion of the alternatives considered and the Board's reasons for accepting some and rejecting others. Individual Board members gave greater weight to some factors than to others.

15. Under the financial accountability criteria established in Statement 14, the inclusion of legally separate organizations in the reporting entity is based on either the appointment process or fiscal dependency. Certain entities, however, are affiliated with legally separate organizations, created for the specific purpose of providing financial assistance or other types of support to their programs without meeting the financial accountability criteria defined in Statement 14. This occurs particularly among colleges and universities; it also occurs among hospitals, museums, elementary and secondary education instititutions, and other types of organizations. Because of the methods used to create and administer some of these organizations, the nature of their relationship is different from what has been set forth in the Statement 14 "financial accountability" criteria.

16. The creation of legally separate entities affiliated with particular governmental entities is facilitated by (a) the ability of groups of individuals to establish not-for-profit corporations under a state's corporation or not-for-profit corporation laws and (b) the existence of IRC 501(c)(3), which provides for exemption of certain types of organizations from the payment of federal income taxes. The articles of incorporation and the by-laws of these organizations may provide for governing boards, a majority of whose members may be officials either employed or appointed by the primary government. For example, the by-laws of an organization may provide that a voting majority of its board members is required to be made up of the primary government's president, development officer, and finance officer. In this situation the organization, even though created under the state's not-for-profit corporation laws, should be evaluated for inclusion in the financial reporting entity under the financial accountability criteria set forth in paragraph 22 and related paragraphs of Statement 14. Often, however, these not-for-profit corporations are organized by individuals (for example, alumni or other interested citizens) who are not directly associated with the primary government, and a voting majority of their governing boards are not appointed by the primary government. Furthermore, the manifestations of fiscal dependency

(such as a requirement to approve the budget) may not exist with regard to these organizations. The Board believes that, despite the absence of direct association through the appointment process or fiscal dependency, the relationships between the primary government and some of these organizations are such that either financial accountability exists through other means or exclusion would render the statements of the financial reporting entity misleading or incomplete.

Underlying Issues

17. The Board considered two underlying issues: (a) In the absence of direct association through the appointment process or fiscal dependency, should the affiliated organizations be included in the financial reporting entity's financial statements? (b) If included in the financial reporting entity, how should they be presented? These two issues are related to each other in the sense that the method of presentation might logically affect whether the organization should be included at all. Among the alternatives considered by the Board were (a) require only extensive note disclosure of financial information for these organizations and (b) attempt to define the *misleading to exclude* provision of Statement 14. The Board also considered requiring blending based on the "exclusive benefit" criterion of Statement 14, paragraph 53b. The Board rejected these approaches because none of them appeared to adequately address the variety of relationships that exist between primary governments and these organizations.

18. In reaching its conclusions, the Board focused on the nature of these relationships by considering the legal documents creating these organizations and their tax-exempt status, the way in which these organizations conduct their activities, and the benefits provided to the primary government. The Board concluded that in certain circumstances these relationships make an affiliated organization an integral part of the primary government reporting entity. The Board also concluded that financial reporting could best recognize the nature of this relationship (in the absence of direct association through the appointment process or fiscal dependency) through discrete presentation of the affiliated organization on the face of the financial reporting entity's financial statements. The circumstances that the Board considered are discussed next.

Criteria for Including Affiliated Organizations

19. This Statement sets forth three criteria to define an affiliated organization, all of which should be met to qualify (paragraph 3). The Board believes that the representations made by a legally separate organization in its articles of incorporation and its applications for exemption from payment of federal income tax

would in certain circumstances be tantamount to the appointment of a voting majority of an organization's governing board.

20. The articles of incorporation (sometimes called "certificate of incorporation" or "articles of association") are the basic instrument filed with the appropriate governmental agency upon incorporation of an organization. The articles of incorporation provide evidence of corporate existence and set forth such matters as the name of the organization, its purpose, its duration, and the number and election of directors. Articles of incorporation filed by affiliated organizations typically indicate affiliation with a specific entity, such as a college or hospital, by inclusion of the name of the specific entity within the name of the affiliated organization and by reference to the specific entity in its statement of purpose—for example: "The name of the corporation is State University of X School of Education Foundation. The purposes of the corporation shall be to aid and assist the State University of X School of Education, whether by financial assistance or otherwise, in achieving its objectives."

21. IRC 501(c)(3) exempts from the payment of federal income tax "corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, or educational purposes . . . , no part of the net earnings of which inures to the benefit of any private shareholder, or individual. . . ." Under current regulations, organizations seeking tax exemption are required to file a Form 1023, "Application for Recognition of Exemption," with the Internal Revenue Service. The application calls for (among other information) a copy of the articles of incorporation, a description of the organization's activities (including the sources of financial support and specific identification of the services performed), and a statement of its control and accountability relationships with other organizations. These applications for tax exemption are public documents and would provide clear evidence of the undertaking of activities in support of a specific governmental entity.

22. Representations as to the purpose of an organization are carried through in the conduct of its activities. Because of the nature of the organization, it is clear to potential donors or grantors that the organization's efforts are on behalf of and in the name of a specific entity. The Board believes that the primary government's acceptance of the benefits resulting from the organization's efforts confirms the entire cycle of creation of the organization for the entity's benefit, seeking and obtaining tax exemption for its benefit, and raising funds or providing services for its benefit. The Board is not aware of any instances where this cycle

has been completed without direct approval or indirect endorsement by the primary government. Therefore, the Board believes that this cycle confirms the primary government's accountability for those organizations.

23. The boundaries of the financial reporting entity in both the public and private sectors traditionally have been defined in terms of control or oversight responsibility (for example, through voting shares of stock, appointment and removal of the governing body, or approval of budgetary or other actions). The ability of individuals not directly associated with a specific entity to organize not-for-profit corporations exempt from payment of federal income tax has caused the creation of affiliates whose primary purpose is to provide financial resources to a specific primary government where there is no fiscal dependency.

24. Although the Board believes the organizational criteria set forth in paragraph 3 to define an affiliated organization are equivalent to appointment of a voting majority of the governing body within the context of assessing financial accountability, it did not conclude that these organizational criteria alone should serve as the basis for requiring inclusion. Consistent with the conclusions reached in Statement 14, the Board believes financial accountability benchmarks of imposition of will and financial benefit or burden should also be assessed.

Imposition of Will

25. Paragraph 26 of Statement 14 sets forth specific conditions that indicate that a primary government has the ability to impose its will on an organization. Several of these conditions may not apply to most affiliated organizations; however, other conditions may indicate that a primary government has the ability to impose its will on an organization. For example, the primary government may appoint the management of the affiliated organization or approve and countersign all checks of the organization, or there may be a written agreement between the primary government and the affiliated organization concerning the establishment of policies and procedures.

Financial Benefit to or Burden on a Primary Government

26. Paragraphs 27–33 of Statement 14 establish the conditions in which a financial benefit to or a burden on a primary government exists. The Board's intent is not to modify the application of these conditions in this Statement. As noted in paragraph 29 of Statement 14, the *ability* to access resources "should be judged in light of the organization as a going concern; that is, a residual interest in the net assets of an organization in the event of dissolution is not equivalent to being entitled to its resources."

27. The Board believes that the nature of an affiliated organization's relationship with a primary government generally will not impose a financial burden on the primary government; however, there may be some circumstances where the primary government is legally obligated or has otherwise assumed the obligation to finance the deficits of, or provide financial support to, the organization—for example, the primary government provides administrative and accounting support for the affiliated organization or the primary government provides space or staff to the organization.

Misleading to Exclude

28. The Board recognizes that there may be circumstances in which the primary government concludes that excluding an organization that does not meet the component unit criteria in Statement 14 or this Statement would nevertheless result in misleading or incomplete financial statements. The Board believes that the determination of whether it would be misleading to exclude an organization is a matter of professional judgment. However, the responsibility to decide whether it would be misleading rests with the primary government, not with the potential component unit.

Reporting Affiliated Organizations

Component Units

29. This Statement provides that all affiliated organization component units should be reported discretely. The Board reached this conclusion because it believes that the absence of direct association through the appointment process or fiscal dependency would cause blending to overstate the relationship between the primary government and the affiliated organization.

30. The Board recognizes that it may sometimes be difficult to obtain financial statements for affiliated organization component units. However, it is anticipated that, over time, financial statements of affiliated organizations will increasingly become available as primary governments and financial statement users begin to focus on the issue.

31. This Statement also provides guidance for reporting transactions between the primary government and affiliated organization component units, based on the form those transactions take. Reporting on direct payments from an affiliated organization component unit to the primary government is covered by Statement 14, paragraph 57; reporting for on-behalf payments for salaries and fringe benefits is covered by Statement 24, paragraph 14. Paragraph 5 of this

Statement requires payments by an affiliated organization component unit of other expenditures for which a primary government is legally liable (for example, utility bills) to be reported as transfers-out and transfers-in. On the other hand, payments by an affiliated organization component unit of expenditures for which the primary government has not incurred a liability (for example, an affiliated organization makes a direct purchase of books for a primary government's library) would not be reported as transfers-out and transfers-in, but would instead be reported as program expenditures by the affiliated organization component unit and would be captioned to indicate benefit to the primary government's programs. Student scholarships paid directly to the students by the affiliated organization component unit should be reported in the same way.

Note Disclosures

32. The Board believes that in cases in which an organization meets the definition of an affiliated organization, as stated in paragraph 3 of this Statement, but does not meet the component unit criteria as provided in paragraph 4, the ongoing relationship between the primary government and the affiliated organization, as described in paragraphs 20–22, should be disclosed in the same manner as required for related organizations in Statement 14.

Alternative View

33. One Board member disagrees with this proposed Statement because he believes that application of the criteria will result in a significant number of affiliated organizations' being reported as component units although little or no control can be exercised by the primary government. He agrees with the proposal in situations in which the primary government can significantly influence the operations of an affiliated organization through imposition of will. However, he does not believe that an affiliated organization's purpose, combined with the financial benefit or burden criteria, indicates that the primary government has the ability to exercise control over the affiliated organization. If a primary government cannot exercise control, this Board member believes that the affiliated organization should *not* be included in the primary government reporting entity.

34. This Board member is particularly concerned with the effect that this proposal will have on special entities. He is concerned that some significantly independent affiliated organizations, including certain foundations, would be reported as component units even though the primary government cannot exercise control over their activities. For example, graduates of a university create an alumni association for the benefit of the alumni and the university. If that association provides financial resources to the university, it would be reported as

a component unit, even though the university has no control over when it will receive the resources or how the resources can be used. Moreover, this Board member is concerned about inconsistencies in reporting that may arise due to structural differences—for example, a school district that may be required to include a parent-teacher organization (PTO) simply because of the method used to create the PTO. If the PTO was created under a state umbrella charter, it would be excluded from the school district's reporting entity. However, if the organization was established under its own charter for the financial benefit of a single school or district, it would be included in the district's reporting entity.

Appendix C

ILLUSTRATIVE EXAMPLES

35. The examples presented in this appendix are intended to illustrate how the provisions of this Statement would be applied to a particular set of hypothetical circumstances. Similar titles (for example, alumni association) may be used for organizations with differing objectives. The examples are for illustrative purposes only and are nonauthoritative. Application of this Statement to individual governments requires consideration of the circumstances specific to that government.

36. Example 1: Library fund-raising foundation

Facts: A fund-raising foundation was created as a legally separate not-for-profit 501(c)(3) organization. The foundation's articles of incorporation specify that its purpose is to provide financial support to a specific government library. The library does not appoint the majority of the foundation's board of trustees or the management of the foundation. The library does not approve the foundation's budget, nor does it directly participate in the foundation's daily operations. All contributions to the foundation, net of expenses, will be given to the library.

Conclusion: The fund-raising foundation meets the definition of an affiliated organization and is a component unit of the library because its stated purpose is to provide specific financial benefits to the library. The fund-raising foundation should be included in the library's financial reporting entity by discrete presentation.

37. Example 2: University fund-raising foundation

Facts: A fund-raising foundation was created as a legally separate not-for-profit 501(c)(3) organization. The foundation's articles of incorporation specify that its purpose is to provide financial support to a specific government university. The university does not appoint the majority of the foundation's board of trustees; however, the management of the foundation is university employees. The university does not approve the foundation's budget, nor does it directly participate in the foundation's daily operations. All contributions to the foundation, net of expenses, will be given to the university.

Conclusion: The fund-raising foundation meets the definition of an affiliated organization and is a component unit of the university because it can impose its will through the appointment of the foundation's management and because its stated purpose is to provide specific financial benefits to the university. The fund-raising foundation should be included in the university's financial reporting entity by discrete presentation.

38. Example 3: College research foundation

Facts: A research foundation was created as a legally separate not-for-profit 501(c)(3) organization. The foundation's articles of incorporation specify that its purpose is to conduct research for a specific government college. The college does not appoint the majority of the foundation's board of trustees or the management of the foundation. The college does not approve the foundation's budget, nor does it directly participate in the foundation's daily operations. The college does not provide any subsidies to the foundation.

Conclusion: The research foundation meets the definition of an affiliated organization but does not meet the criteria of imposition of will or financial benefit or burden. Unless it is determined that the college's financial statements would otherwise be misleading or incomplete by excluding the research foundation, it should be disclosed in the notes of the college's financial statements as a related organization.

39. Example 4: University alumni association

Facts: An alumni association was created by graduates of the university. The alumni association's articles of incorporation specify that its purpose is to support university alumni activities. The university does not appoint the majority of the association's board of trustees or the management of the association. The university does not approve the association's budget, nor does it directly participate in the association's daily operations. The association does not conduct its activities on university property, nor does it provide financial support to the university.

Conclusion: The alumni association does not meet the definition of an affiliated organization because it is not a 501(c)(3) organization created to support the university and because its purpose is to support the alumni, not the university. The association is not part of the university's financial reporting entity and should not be disclosed as a related organization. However, if the alumni association was a 501(c)(3) organization and its stated purpose in the articles of incorporation was primarily to provide financial support to the university, it would be included in the university's financial reporting entity by discrete presentation.

40. Example 5: Hospital fund-raising foundation

Facts: A fund-raising foundation was created as a legally separate not-for-profit 501(c)(3) organization. The foundation's articles of incorporation specify that its purpose is to provide financial support to a specific government hospital. The hospital does not appoint the majority of the foundation's board of trustees or the management of the foundation. The hospital does not approve the foundation's budget; however, the comptroller of the hospital approves all expenses of the foundation and countersigns all checks. All contributions to the foundation, net of expenses, will be given to the hospital.

Conclusion: The fund-raising foundation meets the definition of an affiliated organization and is a component unit of the hospital because the hospital can impose its will through its participation in the daily operations of the foundation and because the foundation's stated purpose is to provide specific financial benefits to the hospital. The fund-raising foundation should be included in the hospital's financial reporting entity by discrete presentation.

41. Example 6: High school booster club

Facts: A high school booster club was established by supporters of the school's athletic activities. The booster club did not incorporate. The school district does not appoint the booster club's management. The school district does not approve the booster club's budget, nor does it directly participate in the booster club's daily operations. All contributions to the booster club, net of expenses, will be given to the high school.

Conclusion: The booster club does not meet the definition of an affiliated organization because it does not meet the purpose criteria in an article of incorporation or an application for tax exemption. The booster club should not be included in the school district's financial reporting entity unless it is determined that the district's financial statements would otherwise be misleading or incomplete. If a high school booster club was created as a legally separate not-for-profit 501(c)(3) organization and had articles of incorporation that specified that its purpose was to provide financial support or services to the high school, it would be included in the schoo district's financial reporting entity by discrete presention.

42. Example 7: Parent–teacher organization

Facts: A local school parent–teacher organization (PTO) was established under the umbrella of a state chapter PTO. The local PTO did not incorporate or file for tax-exempt status; it depends upon the state chapter's tax-exempt status and incorporation.

Conclusion: The local PTO does not meet the definition of an affiliated organization because it has not incorporated and is not a legally separate not-for-profit 501(c)(3) organization. The local PTO is not part of the school district's reporting entity. If a local PTO was created as a legally separate not-for-profit 501(c)(3) organization and its articles of incorporation stated that its purpose was to support a specific school, it would be included in the financial statements of the school district's reporting entity by discrete presentation.

43. Example 8: Hospital physicians' practice plan organization

Facts: A hospital physicians' practice plan organization was created as a legally separate not-for-profit 501(c)(3) organization. The plan's articles of incorporation specify that its purpose is to provide support to the plan. The hospital does not appoint the majority of the plan's board of trustees or the management of the plan. The hospital does not approve the plan's budget, nor does it directly participate in the plan's daily operations. The plan reimburses the hospital for use of its facilities.

Conclusion: The hospital physicians' practice plan organization does not meet the definition of an affiliated organization because its purpose is to support the plan, not the hospital. The organization is not part of the hospital's financial reporting entity. If the plan's stated purpose is to provide support to the hospital and it is paying the physicians a salary for services to the hospital (on-behalf payments), the plan would be included in the hospital's financial reporting entity by discrete presentation.

Appendix D

ILLUSTRATIVE FINANCIAL STATEMENTS AND DISCLOSURES

44. The following examples illustrate the discrete presentation of a fund-raising component unit and illustrate the disclosures required by this Statement. The examples are for illustrative purposes only and are nonauthoritative.

45. Example 1 presents the current model (AICPA College Guide model) balance sheet and statement of changes in fund balances. Changes to the original statements are shaded.

Example 1

Balance Sheet
June 30, 19XX

	Current Funds	Loan Funds	Endowment and Similar Funds	Plant Funds	Agency Funds	**Affiliated Organization Component Units**
ASSETS						
Cash	$13,624,476	$ 146,417	$ 24,200	$ 9,326,172	$ 174,153	**$ 2,139,000**
Short-term investments	5,252,759	31,045	1,604,689	1,496,892	593,620	**4,216,000**
Accounts receivable	2,353,884	—	3,213	—	55,423	**661,000**
Due from other funds	602,701	—	—	12,000	—	**—**
Inventories	885,874	—	—	—	—	**11,000**
Other assets	83,041	—	—	—	349,222	**950,000**
Notes receivable	708	2,222,264	—	—	—	**—**
Long-term investments	159,006	—	16,944,034	—	—	**9,123,000**
Investments in real estate	—	—	6,426,555	—	—	**—**
Mortgages receivable	—	—	171,526	—	—	**—**
Investment in plant:						
Land and improvements	—	—	—	8,485,189	—	**560,000**
Buildings	—	—	—	115,480,150	—	**250,000**
Furniture, fixtures, and equipment	—	—	—	36,739,575	—	**110,000**
Library books	—	—	—	61,872,915	—	**—**
Total assets	$22,962,449	$2,399,726	$25,174,217	$233,412,893	$1,172,418	**$18,010,000**

LIABILITIES						
Accounts payable and accrued liabilities	$ 3,969,717	—	—	$ 458,089	$ 48,290	**$ 431,000**
Retainage payable	—	—	—	421,374	—	**—**
Deposits and deferred revenue	4,570,213	—	—	—	—	**21,000**
Deposits held in custody for others	—	—	—	—	1,124,128	**—**
Due to other funds	12,000	—	$ 602,701	—	—	**—**
Compensated absences	3,577,984	—	—	—	—	**192,000**
Notes payable	—	—	—	2,020,525	—	**1,231,000**
Lease obligations	—	—	—	2,757,797	—	**—**
Long-term debt	—	—	—	27,337,607	—	**—**
Total liabilities	12,129,914	—	602,701	32,995,392	1,172,418	**1,875,000**
FUND BALANCES						
Unrestricted funds	6,886,448	—	—	—	—	**—**
Restricted funds	3,946,087	—	—	—	—	**7,300,000**
Loan funds, U.S. government grants	—	$2,289,318	—	—	—	**—**
Loan funds, college	—	110,408	—	—	—	**—**
Endowment funds	—	—	17,728,702	—	—	**8,835,000**
Quasi-endowment funds	—	—	6,842,814	—	—	**—**
Unexpended plant funds	—	—	—	457,984	—	**—**
Renewal and replacement funds	—	—	—	1,498,317	—	**—**
Retirement of debt funds	—	—	—	254,341	—	**—**
Net investment in plant	—	—	—	198,206,859	—	**—**
Total fund balances	10,832,535	2,399,726	24,571,516	200,417,501	—	**16,135,000**
Total liabilities and fund balances	$22,962,449	$2,399,726	$25,174,217	$233,412,893	$1,172,418	**$18,010,000**

Example 1 (continued)

Statement of Changes in Fund Balances
For the Year Ended June 30, 19XX

	Current Funds				Plant Funds				
	Unrestricted	Restricted	Loan Funds	Endowment and Similar Funds	Unexpended	Renewal and Replacements	Retirement of Debt	Investment in Plant	Affiliated Organization Component Units
REVENUE AND OTHER ADDITIONS									
Unrestricted current fund revenue	$118,381,655	—	—	—	—	—	—	—	$ 431,000
Restricted									
State appropriations	—	$ 2,196,045	—	—	$ 864,946	—	$1,053,804	—	—
Federal grants	—	10,881,696	$ 52,129	—	—	—	—	—	—
State grants	—	1,246,890	—	—	—	—	—	—	—
Local grants	—	1,419,601	—	—	—	—	—	—	—
Private gifts and grants	—	—	—	$ 85,203	172,232	—	—	$ 68,581	6,731,000
Investment income (loss)	—	688,740	50,156	964,511	—	$(64,725)	(12,322)	—	1,621,000
Expended for plant facilities (including $5,580,192 charged to current funds)	—	—	—	—	—	—	—	7,761,824	—
Retirement of debt (including $658,423 charged to current funds)	—	—	—	—	—	—	—	2,527,431	—
Other	—	—	—	—	422,335	—	—	—	238,000
Total revenue and other additions	118,381,655	16,432,972	102,285	1,049,714	1,459,513	(64,725)	1,041,482	10,357,836	9,021,000

EXPENDITURES AND OTHER DEDUCTIONS									
Educational and general	82,214,133	17,558,154	—	—	—	—	—	—	—
Auxiliary enterprises	31,977,500	52,776	—	—	—	—	—	—	—
Foundation expenditures	—	—	—	—	—	—	—	—	2,994,300
Indirect costs recovered	—	2,420,823	—	—	—	—	—	—	—
Expended for plant facilities (including $520,857 not capitalized)	—	—	—	—	2,553,889	148,600	—	—	—
Retirement of debt	—	—	—	—	—	—	1,869,008	—	201,000
Interest on debt	—	—	—	—	—	—	1,330,126	—	183,000
Disposal of plant assets	—	—	—	—	—	—	—	2,339,957	—
Other	—	—	28,417	—	—	—	—	—	—
Total expenditures and other deductions	114,191,633	20,031,753	28,417	—	2,553,889	148,600	3,199,134	2,339,957	3,378,300
TRANSFERS AMONG FUNDS									
Mandatory for principal and interest	(2,156,790)	—	—	—	—	—	2,156,790	—	—
Nonmandatory	(489,089)	3,574,381	2,000	—	469,408	55,420	(55,420)	—	(3,558,700)
Total transfers among funds	(2,645,879)	3,574,381	2,000	—	469,408	55,420	2,101,370	—	(3,558,700)
Net increase (decrease) for the year	1,544,143	(24,400)	75,868	1,049,714	(624,968)	(157,905)	(56,282)	8,017,879	2,088,000
Fund balance—beginning of the year	5,342,305	3,970,487	2,323,858	23,521,802	1,082,952	1,656,222	310,623	190,188,980	14,049,000
Fund balance—end of the year	$ 6,886,448	$ 3,946,087	$2,399,726	$24,571,516	$ 457,984	$1,498,317	$ 254,341	$198,206,859	$16,136,000

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46. Example 2 illustrates the disclosures required by this Statement if the organization meets the criteria of an affiliated organization (paragraph 3), but does not meet the criteria of a component unit (paragraph 4).

Example 2

> The foundation of the college was incorporated specifically to conduct research for the college; however, the college's accountability for the foundation does not extend beyond this affiliation.

Appendix E

CODIFICATION INSTRUCTIONS

47. The sections that follow update the June 30, 1994, *Codification of Governmental Accounting and Financial Reporting Standards* for the effects of this Statement. Only the paragraph number of this Statement is listed if the paragraph will be cited in full in the Codification.

* * *

DEFINING THE FINANCIAL REPORTING ENTITY SECTION 2100

Sources: [Add the following:] GASB Statement XX

.101 [Revise the fifth sentence as follows:] In addition, this section should be applied to governmental and nongovernmental component units, including **affiliated organizations,** when included in a governmental financial reporting entity. [GASBS 14, ¶1 and ¶9; GASBS XX, ¶2]

[Add the following after current paragraph .123, renumbering remaining paragraphs:]

Affiliated Organizations

.123A [GASBS XX, ¶3] [Change "Statement" to "section" and change cross-reference in footnote.]

.123B The relationship of an affiliated organization, as defined in paragraph .123A, to a specific primary government is tantamount to appointment of a voting majority of the affiliated organization's governing board. Accordingly, an affiliated organization should be reported as a component unit of the primary government if the primary government has the ability to *impose its will* on that organization (as discussed in paragraphs .124 and .125) or there is a potential for the organization to provide specific *financial benefits* to, or impose specific *financial burdens* on, the primary government (paragraphs .126–.132). [GASBS XX, ¶4]

.140 [Revise paragraph as follows:] In addition, other organizations should be evaluated as potential component units if they are closely related to the primary government. It is a matter of professional judgment to determine whether the nature and the significance of a potential component unit's relationship with the primary government warrant inclusion. There may also be circumstances warranting inclusion of a single-employer defined benefit public employee retirement system (PERS) that does not meet the criteria for inclusion in paragraph .120 in the financial reporting entity. [GASBS 14, ¶41, as amended by GASBS XX]

DEFINITIONS

.501 [Add the following:]

Affiliated organization

An organization that meets all of these criteria:

a. The organization has separate legal standing, where neither direct association through appointment nor fiscal dependency exists.
b. The affiliation with a specific primary government is set forth in the organization's articles of incorporation—for example, by reference to the name of the primary government in describing the purposes for which the organization was established.
c. The affiliation with a specific primary government is set forth in the organization's application to the Internal Revenue Service for exemption from payment of federal income tax pursuant to Internal Revenue Code (IRC) 501(c)(3)—for example, by reference to the name of the primary government in response to any of the questions contained in the exemption application—and the organization has been granted that exemption.

[GASBS XX, ¶3]

• • •

REPORTING ENTITY AND COMPONENT UNIT PRESENTATION AND DISCLOSURE

SECTION 2600

Sources: [Add the following:] GASBS XX

[Add the following after current paragraph .117, renumbering remaining paragraphs and footnote:]

Reporting Affiliated Organizations

.117A Notwithstanding the provisions of paragraph .116b, an **affiliated organization** component unit (defined in Section 2100, paragraphs .123A and .123B) should be included in the financial reporting entity by discrete presentation.[5] [GASBS XX, ¶5]

[Add the following after current paragraph .121, renumbering remaining paragraphs:]

Affiliated Organizations

.121A Grants, allocations, and other types of assistance made to or on behalf of the primary government by an affiliated organization component unit should be identified in the separate financial statements of the discretely presented affiliated organization and reported in the primary government's financial statements in accordance with the intra-entity transaction and balance requirements of paragraph .120 of this section. If these benefits are not paid directly to the primary government, they should be reported as follows:

a. Salaries and fringe benefits on behalf of primary government employees should be classified as transfers-out and transfers-in, in accordance with GASB Statement No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance,* paragraph 14.
b. Other payments for which the primary government is legally liable, such as utility bills, should also be reported as transfers-out and transfers-in.

[GASBS XX, ¶5]

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[5] [GASBS XX, fn4]

• • •

COLLEGES AND UNIVERSITIES SECTION Co5

Sources: [Add the following:] GASBS XX

[Add the following after current paragraph .108, renumbering remaining paragraphs:]

Affiliated Organizations

.108A–E [GASBS XX, ¶3–¶7] [Change "Statement" to "section" and change cross-references.]

• • •

HOSPITALS SECTION Ho5

Sources: [Add the following:] GASBS XX

[Add the following after current paragraph .105:]

Affiliated Organizations

.106–.110 [GASBS XX, ¶3–¶7] [Change "Statement" to "section" and change cross-references.]

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